



**MBA's COMMERCIAL/MULTIFAMILY FINANCE**

Role of Insurance Companies in  
the Financing of Commercial and  
Multifamily Real Estate in America

By Sam Davis

# About the Author

## Sam Davis

Sam Davis, a Partner at Camden Consulting Group, provides leadership consulting services to both senior leaders and emerging high potential leaders across industries. He has a practice specialty working with leaders in the Investment Management, Commercial Real Estate and Financial Service industries.

Prior to joining Camden, Sam was the Senior Vice President and Senior Managing Director of the Private and Alternative Investments Group at the Allstate Insurance Company. In this role, Sam was responsible for managing \$19 billion of assets, including commercial real estate, private placement bonds, private equity, project finance, infrastructure, energy and timber. Prior to that, he was the Head of Commercial Real Estate Investment for both Allstate and the John Hancock Insurance companies. The primary focus of Sam's investment management career was 24 years in commercial mortgage lending, overseeing both the John Hancock and Allstate Insurance portfolio lending businesses.

Sam is a nationally recognized leader in the real estate finance industry and has been quoted in *The Wall Street Journal* and has spoken at numerous industry events. He is a member of the Board of Directors of the Greater Boston Food Bank.

# About MBA

The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 280,000 people in virtually every community in the country. MBA represents all segments of the real estate finance industry, uniting the interests of diverse stakeholders, from main street to wall street, spanning all aspects of real estate finance, including commercial, multifamily and residential. Our membership of over 2,300 companies includes all elements of real estate finance: mortgage banking companies, insurance companies, commercial banks, thrifts, REITs, securitization conduits, and others in the mortgage lending field. As the leading advocate for the real estate finance industry, MBA represents and serves our members through advocacy, networking opportunities, news, data and leadership. For additional information, visit MBA's web site: [mba.org/cref](http://mba.org/cref) or contact us at [cref1@mba.org](mailto:cref1@mba.org).

# Table of Contents

- Executive Summary . . . . . 4
  
- I. Introduction — The Key Role of Insurance Companies  
in Commercial Real Estate (CRE) Finance . . . . . 5
  
- II. Why Insurance Companies Invest in Commercial and Multifamily Mortgages . . . . . 7
  - Asset Allocation to Commercial Mortgages . . . . . 8
  - Investment Risks. . . . . 8
  - The Search for Yield. . . . . 9
  
- III. History of Insurance Company Lending in CRE Debt . . . . . 10
  - Long Histories . . . . . 10
  - The Early 1990’s Recession: A Defining Time for Insurance Company Lending . . . . . 10
  - Commercial Real Estate Becomes an Institutional Asset Class . . . . . 11
  - Traditional Lending Roles are Changing . . . . . 12
  
- IV. Why Insurance Companies are Important to the Lending Market . . . . . 13
  - Relationship Lenders with Long Service Employees . . . . . 14
  - How Insurance Companies Originate Loans — Two Models . . . . . 14
  - Preferred Providers of Moderate Leverage with a Long-Term View . . . . . 15
  - Primary Underwriting Focus on Real Estate vs. Borrower . . . . . 15
  
- V. Life Company Regulatory Regime. . . . . 18
  
- Conclusion . . . . . 19

# Executive Summary

- Insurance companies play a significant role in the commercial and multifamily lending market as providers of long-term, fixed-rate mortgage loans for a wide variety of properties in metropolitan markets across the country.
- Through decades of experience including many market cycles, insurers have developed loan structures and underwriting techniques that have become the standard for many competitors entering the long-term lending market.
- Most insurance company loans are originated with the assistance of mortgage bankers or other intermediaries who play an important role between the lender and borrower.
- Insurance company loan portfolios continue to perform extremely well despite increased competition.
- Commercial mortgages are viewed as offering strong relative value as compared to other fixed-rate investment alternatives.

# I. Introduction — The Key Role of Insurance Companies in Commercial Real Estate (CRE) Finance

This paper provides an overview of insurance company lending activities, loan origination methods, why insurance companies invest in mortgages, factors that drive insurance company lending activity, the important relationship with mortgage bankers and the general outlook for insurance company future participation in the commercial and multifamily lending market.

Virtually all insurance companies that are active in CRE lending are members of the Mortgage Bankers Association (MBA). MBA's membership consists of the broad range of capital sources and intermediaries that finance real estate. MBA represents its broad membership before policymakers, delivers industry information and research, provides education and training programs, and convenes market participants at industry conferences and meetings. These activities help its members, including insurance companies, expand their businesses, strengthen company performance and manage operational risk. MBA and its members have successfully worked together for many years to shape and improve the CRE finance industry.

Insurance companies have been playing a significant role in the commercial and multifamily financing market for many decades. Insurance company lenders are viewed as a consistent, relationship oriented, dependable source of liquidity in the real estate market. The concept of long-term, fixed-rate, nonrecourse loans — which insurers pioneered — has been in high demand by borrowers. Because most of the loans originated by insurance companies are held in their portfolios, they have the flexibility to offer loan terms to meet the needs of borrowers. Consequently, insurance companies are known to be strong competitors and a desirable source of capital for high quality loan opportunities in areas across the U.S.

It is challenging to generalize about insurance company lending activity. The industry has a wide variety of lender participants, with various investment needs and different business approaches to filling those needs. Insurance companies also make a wide variety of loans by size. Loan sizes start around \$1 million and can exceed \$100 million. The size of the insurance company and its mortgage portfolio often drive the loan size range that it is comfortable offering. Even though most insurers have traditionally offered long-term, fixed-rate loans, the variety of loan terms and structures has broadened to meet borrower demand and increased competition. Various lenders also have different preferences for specific property types and geographic lending targets. It would not be realistic to try to describe all of the nuances of every lender's activities. Nonetheless, this paper seeks to provide valuable insights into the insurance company lending market. There are, of course, exceptions to many of the general points made.

Life insurance companies have been and continue to be the largest providers of insurance company loans. Other types of insurance companies are also active lenders including property and casualty insurance companies.

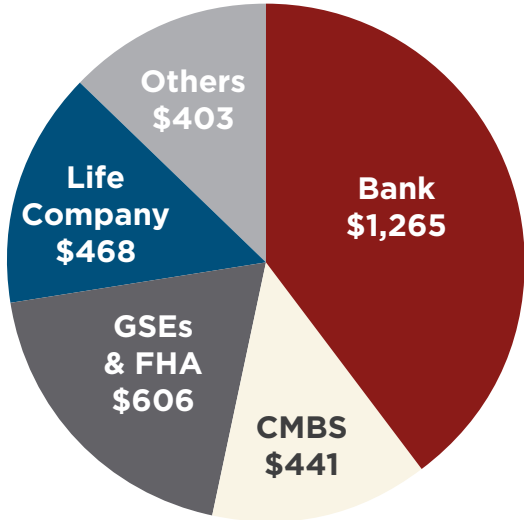
# Market Size and Market Share

The overall U.S. commercial and multifamily debt market outstanding is over \$3.18 trillion in size. Life and other insurance companies are a significant player in this market.

Statistics from the MBA Quarterly Data Book – Q4 2017:

- Total commercial and multifamily debt outstanding: \$3.18 trillion
- Life insurance companies hold 14.7% of all commercial and multifamily debt, equaling \$468 billion
- During 2017 life insurance companies made \$61.03 billion of loan commitments

**FIGURE 1: COMMERCIAL/MULTIFAMILY MORTGAGE DEBT OUTSTANDING Q4 2017 (\$ BILLIONS)**





## II. Why Insurance Companies Invest in Commercial and Multifamily Mortgages

For many insurance products, investment income is one of the major factors that drives product design and pricing. Assumptions are made about investment income that allow insurers to offer various insurance products like life insurance policies and annuities at competitive prices and with structural options that consumers find attractive. Predictable investment income is a significant factor in the overall business success of many insurers. Monthly interest payments from commercial mortgage portfolios have historically been an important component of overall investment income.

Insurance companies have a significant need for long-term (10 to 20 plus year), fixed-income assets, whose monthly and semi-annual interest payment cash flows match well with the long-term payout requirements of products like life insurance policies and annuities. Some life insurance companies today are seeking to find even longer term assets, which have cash flows that match with their very long-term insurance product liabilities. For example, insurers have recently made long-term bond investments in a 40-year term sports stadium financing and a 100-year bond issued by a university. Occasionally, commercial mortgages with terms longer than 20-years will be issued.

Corporate bonds have typically constituted the largest percentage of life insurance company portfolios, but commercial and multifamily mortgages have become a mainstay of investment portfolios, often viewed as a strong relative value alternative to corporate bonds. Commercial and multifamily mortgages have typically been viewed as offering higher risk adjusted returns than corporate bonds in recent years. Returns on commercial mortgages are often compared to current returns available on corporate bonds and private placements with similar risk profiles to determine relative value. These investments come with

call protection features that limit the early payoff of loans without a make whole payment, which ensure the investor will realize the agreed upon yield. Call protection is a critical and attractive feature of these investments, which make future cash flows more predictable.

Investment grade corporate bonds, private placements and commercial mortgages often make up a high percentage of life insurance company investment portfolios. Traditionally, life insurance companies targeted asset allocations that might be along the lines of 80 percent conservative fixed income assets, like investment grade corporate bonds, private placements and commercial mortgages, and 20 percent riskier high yield bond and equity investments. This type of asset allocation has made insurance companies some of the larger and most consistent fixed-income investors in the country for decades.

Other than corporate bonds, private placements and commercial mortgages, it is difficult to find long-term, fixed-rate assets with predictable cash flows and call protection that meet the high volume needs of insurance companies.

## Asset Allocation to Commercial Mortgages

Asset allocations to various types of investments can change from year to year based on factors such as the perceived relative value of investments, market outlook, changing insurance product mix or sales trends and internal or externally driven limits on maximum holdings of a particular asset class. Typically, the commercial mortgage investment operation will receive an allocation of money to invest each year based on the results of the company's asset allocation process. The dollar amount of actual investment made each year may change from the original assumptions based on changing market conditions or changes to any of the other key assumptions in the asset allocation model.

## Investment Risks

Despite the relatively conservative nature of most insurance company investment portfolios, risks do exist that can result in the loss of anticipated income and principal or generate unanticipated volatility of cash flows. Managing these risks is considered a high priority within insurance company investment operations:

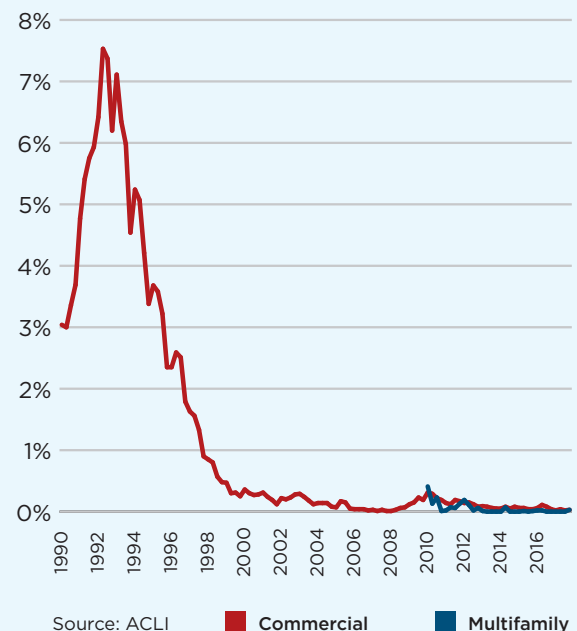
1. **Credit Risk** is the risk of incurring a financial loss as a result of a commercial mortgage failing to make all of its contractual principal and interest payments, including the balloon payment due at the maturity date of the loan. Over time lenders anticipate that loan defaults will occur and losses will be taken. Lenders make assumptions about the percentage of loans that will default and the severity of the losses that will be generated by the loan defaults. These assumptions are usually based on some combination of default and loss experience at the specific lending institution and industry wide statistics. This "loan loss" assumption is quantified into basis points and is a component of the pricing of each commercial mortgage made. As shown in **figure 2**, loan losses historically spike above the priced-in loss assumptions during recessionary periods and stay below the assumed loss level during more positive economic environments. Actual loss experience at a lender can have a significant impact on future allocations of investment to the asset class.
2. **Asset Liability Matching** is the critical need to match the future incoming cash flows generated by investment assets with the projected outflows required by company liabilities, such as life insurance benefit payments or payments due to holders of annuities. Asset liability matching is an important risk

management function at life insurance companies and one of the most significant risks they manage. It is not unusual for insurance companies to have teams of actuaries that develop complex quantitative models that project both asset and liability cash flows for many years into the future. Mismatches in these cash flows can cause significant financial problems for life insurers. To better match these cash flows, insurance companies sometimes employ the use of derivatives and other financial instruments. Today, life insurers face the challenge of not being able to find enough long assets to match with long-dated projected liability cash flows. Insurance regulators often look closely at and take comfort in the careful process that insurers go through to match dependable cash flows from high quality assets to the liabilities of the company.

## The Search for Yield

The low interest rate environment that has existed for several years has negatively impacted insurance company earnings. To be successful, life insurers must maintain their corporate credit ratings by managing all the risks of their complicated businesses well. At the same time they man-

**FIGURE 2: LIFE COMPANIES 60+ DAY DELINQUENCY RATE, INCLUDING IN PROCESS OF FORECLOSURE**





age risk, they need to generate returns that are attractive to their investors and policy holders. These two goals are often difficult to balance. The Chief Investment Officers of life insurance companies are regularly challenged to generate higher returns without taking additional risk. As investments that have been on the books of insurers for many years payoff and their higher yields leave the portfolio, the income from most insurance company investment portfolios have declined. Investment income is often a significant component of overall company income for most life insurers. This is a significant challenge. There is constant discussion about how to increase investment income, while staying within the multiple risk and capital restrictions that must be adhered to.

Insurance company lenders have started to offer a wider variety of loan products in an attempt to generate higher returns. To date, this higher yield lending has been a small percentage of their overall portfolio lending activities. The higher yield loan products that are offered by a few insurers include subordinate debt such as mezzanine loans and “B” notes, floating rate transitional property loans and construction loans. As an alternative to becoming a direct lender in the higher leverage loan market, some insurers have made modest investments in debt funds that specialize in these loan products.

Insurance company lenders are also using their platforms to generate fee income by raising third party capital and charging investment management fees to originate and service loans for institutional capital sources, like pension funds. This is not a large market, but one that a few insurance companies have been participating in for many years. It has proven difficult for a number of portfolio lenders to make the transition from portfolio lending to becoming a successful third-party investment manager. The transition typically takes many years and some organizations have not been in a position to make the transition.

# III. History of Insurance Company Lending in CRE Debt

## Long Histories

Many insurance companies have been in business for a very long time and have been active in real estate lending in various ways for many years. Lending on real estate for some insurance companies started in the 1800s with loans on single-family homes and farmland and grew into commercial real estate. One of the largest life insurance companies is said to have been making commercial mortgages for over 100 years.

An insurance company mortgage department historical document revealed that the company made its first home and farm loans in the 1860s. A senior manager of the company's mortgage operation had been an officer in the Civil War. The growth of railroad travel had a major influence on business growth during this era. By the early 20th century, the railroads were an efficient method of travel between major cities. Members of the mortgage department traveled by train all over the country to inspect properties and meet with correspondents (mortgage bankers that represented the insurance company in specific markets around the country) to discuss new lending opportunities and inspect properties securing loans in the portfolio. Correspondents at the time would pick the lenders up at the train station in early automobiles or by horse and buggy. Thousands of miles of train travel were required each year as portfolios grew. This type of extraordinarily long history has created deep institutional knowledge and well informed lending practices at many institutions.

Real estate lending has been and continues to be an important piece of many insurance companies' investment activities. As a result, insurance company real estate lending activities have been remarkably consistent for many decades. There were, of course, lending slow-downs during war times and recessionary periods. However, the post-World War II era marked growth in overall lending and the emergence of commercial and multifamily lending activity. Many of the correspondent relationships with mortgage bankers that began decades earlier on the single-family

and farm sides of the business evolved into commercial mortgage lending relationships over time.

These long years of lending experience through various market and interest rate cycles have positioned many insurance company lending operations as some of the most knowledgeable, relationship oriented, dependable sources of capital able to structure solutions to solve borrowers' business challenges.

Insurance companies were the creators of the long-term, fixed-rate, nonrecourse loan. For many years, insurance companies were almost the exclusive providers of these loans. Historically, insurers were in a uniquely advantageous position in the marketplace. There were more borrowers that sought long-term fixed-rate loans than there was money available. This was a luxurious competitive position to be in, but new competition arrived in the form of Commercial Mortgage Backed Securities (CMBS) and Fannie Mae and Freddie Mac in financing multifamily properties. Today, banks are also competitors in the long-term, fixed-rate loan space once dominated by life companies.

## The Early 1990's Recession: A Defining Time for Insurance Company Lending

The 1990–91 recession sent shockwaves throughout the commercial and multifamily real estate industry, including the insurance company lending market. This short-lived recession, which according to government statistics lasted only 8 months, from July 1990 through March 1991, had a very negative impact on almost all aspects of the real estate industry. These forces set in motion changes that have redefined the landscape of the lending business for the past 25 years. Insurance company lenders lost their enviable position as almost the exclusive source of long-term, fixed-rate loans. At the same time, as competitive pressure and regulatory oversight increased, insurers became more sophisticated in their approaches to risk management, loan underwriting and portfolio management. They also

learned to become better marketers of their loan offerings and more creative product developers.

A number of factors aligned to make the 1990–91 recession particularly damaging to the real estate industry. The 1986 tax law changes eliminated significant tax incentives to invest in commercial and multifamily real estate. These tax incentives had fueled overbuilding in many markets, creating over supply and high vacancy rates. The tax changes put an end to the mid-1980s real estate boom. When tax driven investors exited the market, asset values dropped rapidly and led to a significant number of loan defaults. The Savings and Loan (S&L) industry was in trouble in the 1980s and deregulation allowed the S&L industry to lend on commercial real estate. As S&Ls began to fail in large numbers, it became apparent that their commercial and multifamily loan portfolios were incurring significant losses. At the same time, it was difficult to refinance properties because interest rates were high.

Before the national recession officially started in 1990, the oil states, as they were called at the time, Texas, Oklahoma, Louisiana and Colorado, had already been experiencing significant economic downturns for a few years. The defense industry was experiencing significant job cuts that impacted places like California, New England and other pockets across the country. Because of the overbuilding going into the recession and what was referred to as a jobless recovery, the impact on real estate was painful. Asset values dropped rapidly, rents declined significantly in most markets and loan defaults spiked to damaging levels. Bank failures swept across the country. There was no significant liquidity in the real estate finance market for a period of time. Most loans could not be financed or refinanced. This period of illiquidity drove property values further down and created a sense of desperation in the market. Many of the most prestigious owners and operators of real estate suffered significant losses during this time. The insurance industry reported average loan defaults (more than 60 days delinquent) of over 7% in 1992. A similar percentage of insurer loans were restructured at the same time, almost doubling the delinquency percentage. A number of insurance companies suffered downgrades in their credit ratings as a result of losses on their commercial mortgage portfolios. The Resolution Trust Corporation (RTC) was formed by the government to take control of the assets from failed S&Ls and recover as much money as possible. The RTC in partnership with Wall Street investment bankers created securitization transactions to sell assets and recover money, usually structured as liquidating trusts that were expected to incur losses. These

RTC securitization transactions helped create the deal structures, rating agency methodologies, investor base and market, which would help launch the CMBS industry. The CMBS industry was one of the public sources of capital along with the growth of the REIT industry that started to transform the commercial real estate industry from a private cottage industry to an institutional asset class.

Much has changed since the early 1990s, particularly related to commercial mortgage portfolio risk management and availability of commercial real estate market data. The combination of a much more transparent commercial mortgage marketplace and a more sophisticated approach to managing portfolio concentration risks has reduced the likelihood of repeating the mistakes of the past.

### **Commercial Real Estate Becomes an Institutional Asset Class**

Following the 1990–91 recession and the real estate problems that followed including a period of damaging illiquidity, the CMBS market was created. The ability to securitize commercial mortgages tapped into a significant new source of capital for the real estate industry, the public bond market. The CMBS market required a high level of data to function and satisfy investor and rating agency demands. Data standards were created and new providers of data emerged to meet these needs. The transparency that was created by this public commercial mortgage market impacted all participants in the market and has been one of the factors that has attracted more institutional investors to commercial real estate. There is also a belief that periods of illiquidity, like the one experienced in the early 1990s, will be reduced or eliminated because of the flow of public capital into the real estate market.

On the equity side of the real estate business, REITs, a public ownership vehicle, had similar impacts on previously private markets. Public market investors, from individuals to institutions, have access to equity real estate investment opportunities on a much larger scale than in the past. These public vehicles for both commercial real estate debt and equity have brought market transparency and discipline to commercial real estate that didn't exist previously. The commercial real estate market has matured significantly in the past 25 years and has become an institutional asset class, which now attracts global capital from financial institutions, pension funds and sovereign wealth funds. Before institutional investors will consider an asset class, they typically look for established markets with demonstrated liquidity, the ability to invest in scale and high quality market data.

Commercial real estate has met most institutional investors' criteria in these areas. This has meant new competition for insurance company lenders, but it has also had positive impacts, including an increase in institutional ownership of property. Institutional investment in an asset class often results in a significant increase in investor activity, available capital, sophistication of market participants, and growth of the segment.

Fannie Mae, Freddie Mac and HUD are the dominant providers of capital to the multifamily finance market. Insurance companies once had the long-term, fixed-rate multifamily financing market to themselves. Now they face formidable competition from Fannie Mae, Freddie Mac and HUD, who are largely limited to multifamily housing among the CRE property types. CMBS lenders also compete with insurers for large, high quality single asset financings that are important to the formation of their securitized pools of loans. Once again, insurance companies are relative value investors who reallocate investment funds based on changing market condition and can adapt based on the competitive environment.

## Traditional Lending Roles are Changing

For many years, there was a clear split between bank and insurance company lending activity. Banks were providers of short-term, floating rate, recourse loans, and insurance companies were the providers of long-term, fixed-rate, nonrecourse loans. Banks would make construction loans and short-term loans used to reposition a property. Once a property was fully leased and stabilized, insurance companies would be approached to provide “permanent financing” in the form of a long-term, fixed-rate, nonrecourse loan that could be assumed by a new owner if the property were to be sold. The insurance company loan locked in the financial terms of the financing for many years, which increased the predictability of the economic return of the real estate investment. This neat split of bank and insurance company lending roles has become less clear in recent years.

As competition from CMBS lenders and Fannie Mae and Freddie Mac increased in the 1990's and has continued to grow for long-term, fixed-rate loans, the types of loans that various lenders make have evolved and in many cases expanded. Competition from the Government-sponsored Enterprises — or GSEs as Fannie Mae and Freddie Mac are commonly known — has significantly increased, for example, in multifamily finance. As one mortgage banker recently said “everybody is in everybody else's business now.” Banks are now making fixed-rate, nonrecourse loans with terms up to 7 years and sometimes longer. Some insurance companies are offering short-term, floating rate financing. A few insurers are offering construction loans. Lending competition has also increased for higher risk, higher leverage loans. This competition comes from specialty lenders, mortgage REITs and mortgage funds. Some insurance companies offer higher leverage loan products that are competitive with these lenders. A number of factors have driven lenders to broaden their product offerings including changes in the regulatory environment, an extended period of positive national economic performance, and a low interest rate environment, which has created a search for investment yield.

# IV. Why Insurance Companies are Important to the Lending Market

When market participants are asked why insurance companies are important to the commercial and multifamily finance market, the responses are often surprisingly similar. Some of the factors that are mentioned frequently are that insurance companies:

- Are strong providers of liquidity to the market
- Are consistently in the market for loan opportunities
- Are providers of a wide variety of loan sizes including large loans
- Will lend on a wide range of collateral
- Are competitive on pricing for high quality transactions
- Have predictable loan underwriting standards
- Have flexibility to structure transactions
- Have long service employees who value relationships with mortgage bankers and borrowers
- Have the ability to lock the interest rate early in the process, increasing the certainty of closing the loan

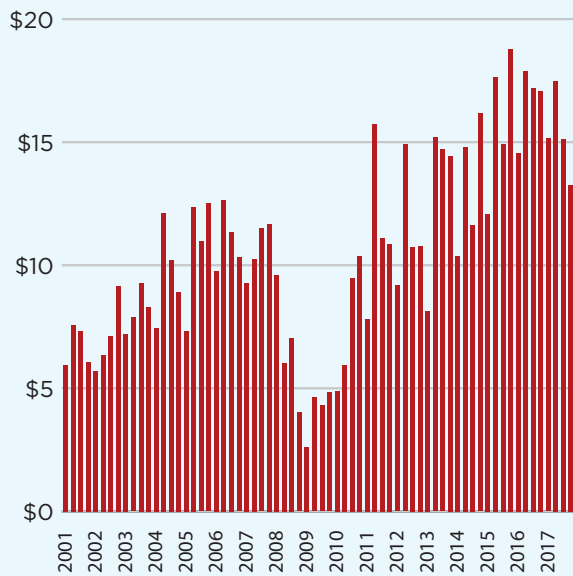
For the reasons mentioned above, insurance companies are a highly desirable source of debt capital for owners of fully leased, stabilized, cash flowing properties.

Insurance company flows of capital for investment come primarily from insurance product sales and issuance of guaranteed liabilities. The sales of traditional whole life insurance, annuities, disability insurance, property and casualty insurance and the issuance of commercial paper and guaranteed investment contracts have all provided investment capital for commercial mortgages over the years. These cash flows are fairly consistent from year to year. On an industry wide basis, insurance companies have committed to \$52 to \$66 billion of new loans every year for the past 4 years according to the MBA Quarterly Data Book. See **figure 3** for quarterly commitments.

A high percentage of insurance company lending is done in the 30 largest metropolitan areas in the country. There are simply more large, high quality real estate assets to lend on in these markets. The liquidity available in the top-30 markets also tends to be more consistent through market cycles, which increases the likelihood that a lender's loan will be paid off at maturity. Insurance company lending is active in smaller and medium sized metropolitan markets as well, but at lower overall dollar volumes.

The property types that have traditionally been the target of most insurance company lending include: multifamily, office, retail and industrial. Smaller percentages of insurance company loan portfolios can be found in a variety of other property types including: hotel, self-storage and parking.

**FIGURE 3: QUARTERLY COMMERCIAL MORTGAGE COMMITMENTS BY LIFE INSURANCE COMPANIES (\$ BILLIONS)**



Source: ACLI

### Relationship Lenders with Long Service Employees

Insurance company lenders place a high value on mortgage banker and borrower relationships. Because of the complexity involved in completing a commercial or multifamily mortgage transaction, lenders want to develop relationships with mortgage bankers and borrowers that they can do multiple transactions with. Once a mortgage banker or borrower completes their first transaction with a lender, they understand the lender’s process and the subsequent transactions are typically much easier to complete. Repeat business is critical to the success of insurance company lenders. A traditional insurance company borrower places value on a long-term relationship with their lender, has a strong credit history and successful investment track record, and understands the benefits of having their loan serviced by a portfolio lender in partnership with a local mortgage banker.

Another significant and unique aspect of relationships with insurance company lenders is the long service nature of their lending staffs. In today’s world, where many corporate employees change jobs every few years, insurance company lending operations stand out for their ability to retain employees long-term. Compared to other industries, there are many people who do stay with one insurance company lender for many years. The ability to transact with the same person or team over a period of years provides mortgage bankers and borrowers a greater sense of consistency and continuity, which increases the level of certainty that they will successfully complete their financing transaction.

### How Insurance Companies Originate Loans – Two Models

Insurance companies have generally chosen one of two business models to originate loans: The correspondent model and the direct/open model.

In the correspondent model, the insurance company has formal agreements with mortgage bankers who are contracted to originate and service loans in a specific metropolitan area or region. The loans that the mortgage banker originates are typically also serviced by the mortgage banker. There may be more than one mortgage banking correspondent in any particular metropolitan area. Exclusive rights to originate loans in a geographic area are rare. This model suggests that any borrower or broker seeking to present a loan opportunity to the lender would need to work through the insurer’s correspondent in that area. Many correspondent relationships have been in place for decades. Insurers will switch correspondents when existing relationships are no longer producing the volume, type and quality of loans that the lender is seeking.

The correspondent model allows the insurer to have a smaller staff. This is a lower cost business model and has its advantages and disadvantages. During periods of low origination volume, having a smaller staff is advantageous. One of the disadvantages of this model is a lack of control over the flow of business through mortgage bankers who are seeking the best loan terms for their borrower client. The mortgage banker is typically compensated by the borrower for originating the loan.



A number of larger insurance company lenders do not have formal correspondent relationships with mortgage bankers and instead will accept loan opportunities from any mortgage banker or borrower. This direct/open business model typically requires a larger staff to cover all of the loan origination responsibilities across the country. Often, open shops have regional loan origination offices to put staff members closer to major markets. Open shop lenders believe that the advantages of this business model include:

- The ability to serve large borrowers who want to deal directly with lenders
- Direct employees on the ground in key markets who know the markets well and develop strong relationships with mortgage bankers and borrowers
- As new loan products are launched, the origination approach and channels can be adapted to the demands of the product and market

Mortgage bankers are still involved in the majority of transactions with direct lenders even though there are no formal correspondent agreements. Mortgage bankers report that if they have an exclusive to represent a borrower on a financing transaction, most lenders will let them bring the opportunity to them directly.

No matter which loan origination model a lender has chosen, the insurance company is actively involved in all the critical steps of the lending process, including: loan application negotiation, underwriting, third party report review, lease review, and approval. The lender controls the process and ultimately makes the decision to fund the loan or not.

### **Preferred Providers of Moderate Leverage with a Long-Term View**

In today's market, insurance companies are most commonly limiting leverage levels to 60–65% loan to value, with some lenders going higher on the leverage scale. With cap rates at historically low levels and many properties at all time high valuations, insurers are limiting leverage to protect against a future valuation correction. Most of the loans made by insurers are held in their portfolios until maturity. Their lending practices are driven by the basic concept that they have significant “skin in the game” on every loan they make. Insurance companies know that they will be living with each loan, if it performs as expected or not. Because insurance companies take a long-term view of risk, they are concerned about over leveraging properties in today's market. To protect against this risk, lenders may

apply underwriting stress tests, which utilize higher than current market interest rate and cap rate assumptions at the time of the loan transaction and at the time of loan maturity. These stress tests, including a loan refinance test at maturity are often limiting factors on the loan amount that an insurer is willing to offer. Insurance companies are viewed by most market participants as conservative lenders that are strong providers of capital to borrowers that are interested in placing a moderate amount of financing on their property, but are not trying to squeeze out the last dollar. Insurers are often able to win moderate leverage financing transactions by offering loan structuring flexibility that is not available from competitors.

As previously noted, insurance company lenders continue to focus most of their lending activity on the 20 to 30 largest metropolitan markets in the country and on the four major property types: office, industrial, retail and multifamily. Some lenders develop lending niches in other property types and do a smaller percentage of their lending on real estate secured by parking, self-storage, hospitality or senior housing facilities. In the past few years, retail lending has become more challenging as the impact of online shopping has been felt. Debates go on daily about the future of various types of retail centers and where it makes sense to lend on a long-term basis.

Insurance companies offer a wide variety of loan sizes, depending on the lender, from \$1 million to over \$100 million. There are a limited number of lenders that will do a single asset loan in excess of \$100 million and even fewer that will go above \$150 million. Occasionally, a high quality, low-leverage single-asset financing will be completed by an insurer in the \$200–\$400 million range. Participations between two or more lenders are common on these very large transactions. Many lenders consider large single asset exposures, above a certain percentage of their total portfolio, as having too much concentrated event risk.

### **Primary Underwriting Focus on Real Estate vs. Borrower**

Because insurance companies have primarily been nonrecourse lenders, they place much of their loan underwriting focus on analyzing the strengths and weaknesses of the property being financed. This property-focused approach is in contrast to the borrower focused approach of recourse lenders. Recourse loans generally allow the lender to pursue the personal assets of the borrower if the loan goes into default. Nonrecourse loans limit the lender to primarily pursuing the property as collateral for the loan in a default situation. The central focus of insurance company

underwriting is the long-term sustainability of cash flow generated by tenant leases. In comparison, banks have traditionally placed more emphasis on the borrower's personal or corporate financial strength as the primary source of repayment of loans, which dictates a different approach to loan underwriting. Insurance companies do assess a borrower's creditworthiness, but typically consider it a secondary factor to underwriting property cash flow. To properly assess the sustainability of cash flow, a number of factors are analyzed, all requiring specialized knowledge and skills. These factors include:

1. **Real Estate Market Dynamics:** The strength of the leasing market for the subject building and directly competitive properties in the immediate sub-market and the broader metropolitan market are examined. What does the supply and demand equation for new space look like in this market, how much new space is being constructed or is in planning stage to be constructed as compared to historical leasing absorption of space? Does the market have significant constraints on building or not? What is the risk of over-building, the potential for market leasing vacancy rates to rise and the cash flow at the property to be negatively impacted?
2. **Leasing/Rent Roll Analysis:** The existing leases in place at the property being financed are typically the primary source of cash flow to pay the monthly mortgage (debt service) payments. The rent levels relative to the market are an important factor. The cash flow analysis takes a detailed look at all sustainable forms of income from the property (leases, parking, expense reimbursements, etc.) and then subtracts the stabilized operating expenses and reserves for capital improvements to calculate a net operating income available to pay debt service. A debt service coverage ratio (DSCR) is calculated by dividing net operating income by the debt service. The DSCR is one of the primary financial ratios used by insurance companies to assess the risk of a loan. In addition, a review of the debt yield has become an important consideration for lenders. The debt yield generally is the net operating income divided by the outstanding loan balance. A lease expiration analysis is also completed, which looks at an annual schedule of lease expirations to assess risk of decreased or interrupted cash flow available to pay debt service during the term of the loan and at the time of loan maturity and refinance. The creditworthiness of tenants is

analyzed as a significant factor that may impact the sustainability of cash flows at the property.

3. **Valuation:** The property's current market value is determined through a number of approaches to commercial property valuation. The valuation process is typically performed internally by members of the mortgage lending operation during the early part of the loan underwriting process and most often verified by a third party independent appraiser before closing the loan. The approaches to property valuation may include current cash flow analysis, discounted future cash flow, comparable sales and replacement cost. Often, the various approaches to valuation are taken into consideration as part of concluding an appraised market value. The proposed loan amount is then divided by the appraised value to generate a loan to value (LTV) ratio, which is another primary financial ratio lenders utilize to assess the risk of a loan. When available, there is no better indicator of the value than a recent or currently agreed upon arms-length sale price for the property being financed.
4. **Refinance Risk:** Most insurance company loans have a significant balloon payment due at the loan maturity date. A common insurance company loan structure might be a 10-year loan term, with a 30-year amortization schedule. An analysis is performed of the ability of the loan to be refinanced on market terms at the maturity date. Because the maturity date of the loan may be 10 or more years in the future, this analysis is based on assumptions about property leasing, interest rates and available loan terms at that future date.

To master the skills required to perform this detailed property cash flow and valuation analysis requires years of experience analyzing loans on various property types in many markets. Some long-time insurance company lenders believe that one needs to have lived with loans that one has underwritten through a market downturn and deal with the problems (loan defaults and workouts) before one can truly have a deep appreciation for the loan underwriting process. Many senior insurance company lenders have experienced more than one market downturn and the resulting problem loans that are almost inevitable during recessionary periods. These are some of most knowledgeable real estate finance professionals in the country.

Despite the fact that insurance companies place a high priority on property cash flow analysis, they do not ignore the borrower in the underwriting of a loan. The primary focus of borrower underwriting is the experience and track record of the key principals of the borrowing entity. How long has the borrower been in the real estate business and how successful have they been? How large is the borrower's portfolio? What is the current cash flow from the borrower's portfolio? Are any of the properties in their portfolio over leveraged? Do they have deep experience owning and operating properties like the one being financed?

The structure of the borrowing entity is also a significant consideration. Is there something about the structure of the borrowing entity that may or may not motivate the borrower to continue to fund the loan payments if the property's cash flow temporarily declines? Insurance companies are sensitive to borrowers that have experienced previous loan defaults, loan restructurings and foreclosures. For borrowers that have experienced problems in the past, an investigation is done into how they behaved. Were they cooperative with the lender? Did they continue to fund the loan even when the property cash flow didn't support the financing? Did they bring other financial resources to the table to make sure the property continued to be maintained and leased during this troubled period? These and other factors are taken into consideration when analyzing the creditworthiness of a nonrecourse borrower. Knowing that the borrower can turn the property over to the lender in a troubled situation and, with some exceptions, walk away without personal liability drives the paramount nature of the lending process and the focus on the real estate.

# V. Life Company Regulatory Regime

Life insurance companies are regulated by state insurance commissioners that are typically members of the National Association of Insurance Commissioners (NAIC). State level commercial mortgage regulations vary somewhat from state to state, but have many common themes, such as requiring a first lien on properties and limiting leverage levels to 75 to 80 percent loan to value. Each state insurance regulator may have their own requirements that can impact the lenders based in that state. Limitations on various asset types, geographic concentrations or riskier assets may be put in place.

The NAIC establishes risk based capital rules for the industry. There was a recent change in the approach to calculating risk based capital (RBC) for commercial mortgages, moving away from the Mortgage Experience Adjustment Factor (MEAF), a portfolio-wide calculation to a loan by loan calculation today. For most companies, this change of calculation reduced the amount of capital required to be held for mortgages. This was a positive change for most insurers as RBC is typically a driver of loan pricing and the allocation of money to the asset class.

In addition to responding to state legislation, insurance companies are also very sensitive about their corporate credit ratings and consequently the credit rating agencies (while not a regulatory body) have an impact on decisions about allocation levels to mortgages and the type of risks being taken in the mortgage portfolio. For public insurance companies, stock analysts keep a close watch on investment portfolio performance and therefore also have some influence on portfolio decisions.

# Conclusion

This paper seeks to provide an informative summary of insurance company commercial and multifamily lending activity. Insurers have and continue to play an important role in the commercial real estate finance industry. They represent a constant presence in the business that many mortgage bankers and borrowers depend on. Insurance company lenders are known for their real estate risk underwriting and loan structuring abilities, which have helped them attract many of the highest quality borrower entities and loan opportunities.

The demand for insurance company loans remains high, which is a tribute to the professionals who run and staff insurance company lending operations, and who have built long-standing relationships with mortgage bankers, borrowers and the industry as a whole.

Moreover, the demand for insurance products that generate investable cash flow for commercial mortgage lending continues to be significant. Insurance companies are in the business of developing new products to meet the needs of their retail and institutional clients. The industry remains stable and insurance companies will maintain a strong presence in the commercial mortgage lending market for years to come.

**MBA<sup>®</sup>**

---

MORTGAGE BANKERS ASSOCIATION

1919 M STREET NW, 5th FLOOR  
WASHINGTON, DC 20036