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Mind the Gap:

Commercial Real Estate Debt and the Opportunity for Insurers

By Clark Coffee and Richard Roberts

The tectonic plates are shifting in the commercial real estate market. High interest rates have reset property values while banks are facing stricter regulatory pressure that has impaired their ability to lend. Financing needs for commercial property owners, on the other hand, are strong and likely to get stronger. This presents a unique opportunity for private, nonbank lenders to fill the gap.

The opportunity in private commercial real estate debt is particularly attractive for insurance investors, who face their own unique challenges. The asset class gives insurers the potential to achieve attractive risk-adjusted returns while matching liabilities and making efficient use of solvency capital budgets.

The opportunity appears especially compelling in Europe, where regulatory changes have been steadily driving banks to reduce capital available to commercial real estate borrowers. Borrowers are turning instead to alternative lenders, and with credit generally less available, these nonbank lenders are increasingly able to negotiate stronger loan terms and higher yields. In this environment, we believe a selective allocation to privately originated commercial mortgages may be an effective way for insurers to broaden exposure to real estate. It also offers an attractive way to enhance risk-adjusted return potential relative to public fixed-income assets with similar credit and duration profiles.

Avoiding a Broad-Brush Approach

Commercial real estate debt is a complex and diverse asset class that may fulfill a number of portfolio needs for institutional investors. MSCI recently put the size of the global investible market at $19.5 trillion in 2022.[1] That is larger than China's economy and within striking distance of the United States'.

There's no denying that commercial real estate faces challenges in today's changing macroeconomic environment. But its many subsectors and the vast differences between individual assets and across geographies make it difficult to paint with a broad brush.

Offices have struggled since the COVID-19 pandemic altered work patterns, forcing many tenants to change how they use space. That has created structural challenges for property owners and made this sector of the commercial real estate universe an area of acute concern for investors.

But market conditions vary by geography. For example, European office occupancy rates are notably higher than those in the United States, where hybrid work arrangements have become more common. Other property types, including industrial and hospitality, still exhibit strong fundamentals. And warehouses and data centers have been big winners in recent years, thanks to growth in online retailing and cloud computing.

1 Source: MSCI https://www.msci.com/documents/10199/9bfc5e27-67d0-48c7-c37e-7f72652d1406

Simply put, no two assets are alike, and differences within and between property types—and across regions—can be significant.

The Advantages of Being a Lender

Rising interest rates, of course, have increased the risk associated with many commercial real estate loans, while stricter regulation is making it harder for banks to lend at the volumes they have in the past. But this provides an attractive opportunity for alternative lenders with capital to invest.

When it comes to commercial real estate, we believe there are distinct advantages associated with being a lender, particularly when compared to equity investments. Loans are secured by the intrinsic value of the underlying collateral—the bricks and mortar that house the hotels, offices, data centers and multifamily apartment complexes. In real estate, even a property with no cash flow can have value.

Another important point: commercial real estate debt is floating-rate debt, so lenders stand to benefit in a higher-for-longer rate environment. Those with strong underwriting standards can tailor new origination to high-quality borrowers, increasing their potential to generate attractive income and absolute returns in an otherwise challenging macroeconomic environment.

Finally, lenders have seniority in the capital structure and are insulated by sizable equity cushions. This suggests that even in a higher-for-longer interest-rate environment that suppresses valuations, debt can continue to perform. Because they sit lower in the capital structure, equity investors face a higher risk of absorbing losses or, in extreme cases, being wiped out entirely.

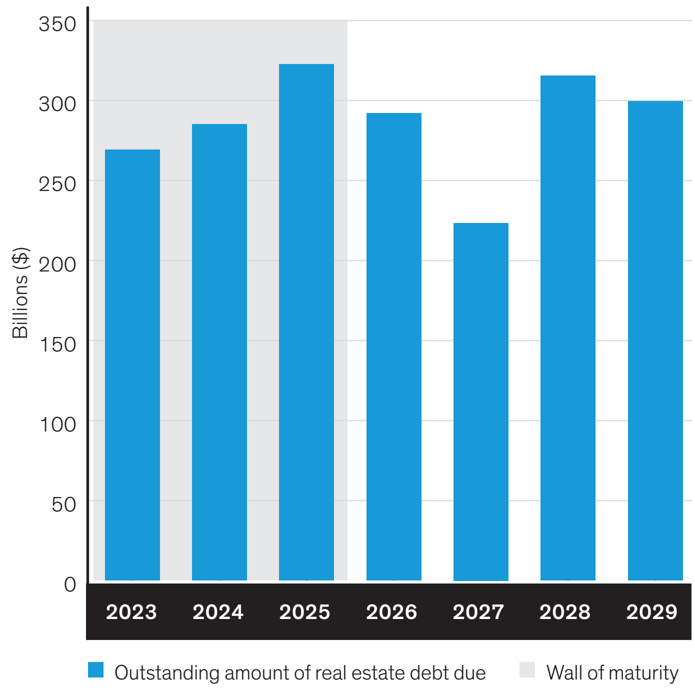
The Opportunity for Insurers

For insurers, we think the advantages of being a lender coupled with the market backdrop and the solvency, risk and return dynamics of commercial real estate debt make this is an opportune time to consider a new or increased allocation to the asset class. The opportunities will be most plentiful for lenders who understand the idiosyncrasies of individual properties and the varying regional trends and conditions across the commercial real estate market.

These opportunities are especially attractive in Europe, where borrowers over the next few years will need to refinance an avalanche of maturing loans. More than €250 billion of commercial real estate debt[2] in continental Europe is due to mature in 2023 alone. That amount swells to €390 billion when maturing UK loans are added to the mix. By the end of 2025, we estimate total European maturities will approach €900 billion (*Display 1*).

DISPLAY 1: HITTING THE (MATURITY) WALL

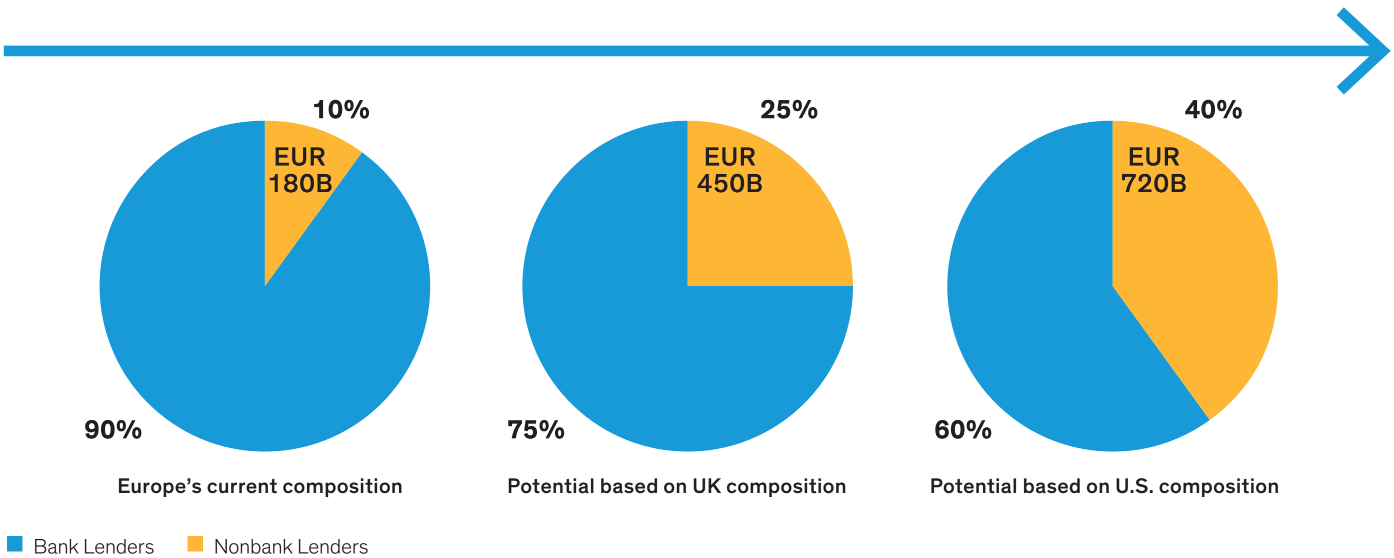
European CRE Debt—Projected Wall of Maturity



As of March 31, 2022 | **Source:** Bayes, Bloomberg, and AB Real Estate

2 Any projections or forecasts presented herein are hypothetical and subject to change without notice. Actual data will vary and may not be reflected here.

DISPLAY 2: THE GROWTH OPPORTUNITY FOR EUROPEAN ALTERNATIVE LENDERS



Historical analysis and current forecasts do not guarantee future results.

As of March 31, 2020 | **Source:** FactSet, S&P and AB

Banks Pull Back

Historically, large European banks would have provided the majority of this financing. Alternative lenders began gaining market share after the Global Financial Crisis, when bank supervisors increased regulation and supervisory controls to shore up capital ratios and reduce systemic risk. But the biggest European banks have maintained a large footprint in real estate finance in general and commercial real estate lending in particular compared to banks in the United Kingdom and United States.

That started to fade with the European Union's implementation of the Basel III global capital rules, which require banks to increase the capital they hold against commercial real estate loans. The European Banking Authority has said that the increase in minimum capital requirements could lead to a total shortfall of €125 billion[3]—leaving banks with little choice but to reduce overall lending.

This will create opportunities for alternative lenders in Europe, who account for about 10% of new commercial real estate origination today (*Display 2*). A 10% reduction in European banks' lending appetite would translate to a near doubling of the market share for alternative lenders. If nonbank lenders can capture a quarter of the total European origination—their share in the UK—we estimate that it would create about €270 billion of additional lending capacity. To match the share of US nonbank lenders, European nonbank lending would have to quadruple from today's levels. This suggests plenty of room for expansion.

The Case for Commercial Real Estate Debt

Commercial real estate debt has the potential to provide equity-like returns with the ability to mitigate downside risk. As banks retreat from the market, private credit providers can target deals backed by stronger assets. They can also negotiate contractual terms that accurately reflect a deal's unique risks, resulting in higher spreads over already elevated base rates. This comes on top of the existing illiquidity premium associated with this buy-and-hold investment.

Alternative lenders today can de-risk deals further by requiring borrowers to keep more skin in the game. Loan-to-value (LTV) ratios for recent transactions have been between 60% and 65% compared with 80% before the pandemic. This provides a substantial equity cushion to absorb losses.

3 Equity attracts a 39% charge for developed markets, but the current symmetric adjustment of –0.74% reduces the final charge to just above 38%.

As banks retreat, **lenders can also negotiate strong covenants**, such as mandating a minimum cash flow. If key milestones aren't hit, they can increase margins, require borrowers to inject more equity, and deny additional acquisition requests. Unlike in the US market, it isn't unusual in Europe to get both—a minimum cash-flow requirement and value covenants. Underlying assets typically span the risk-return spectrum, and deals can be structured in a way that aligns with an insurance investor's risk appetite. This diversification may dampen volatility. Pricing and risk level are determined by several variables, including credit quality, the borrower's history, and the quality of the underlying asset. The range of risk/return profiles within European commercial real estate debt can produce a range of outcomes to meet individual insurance companies' requirements.

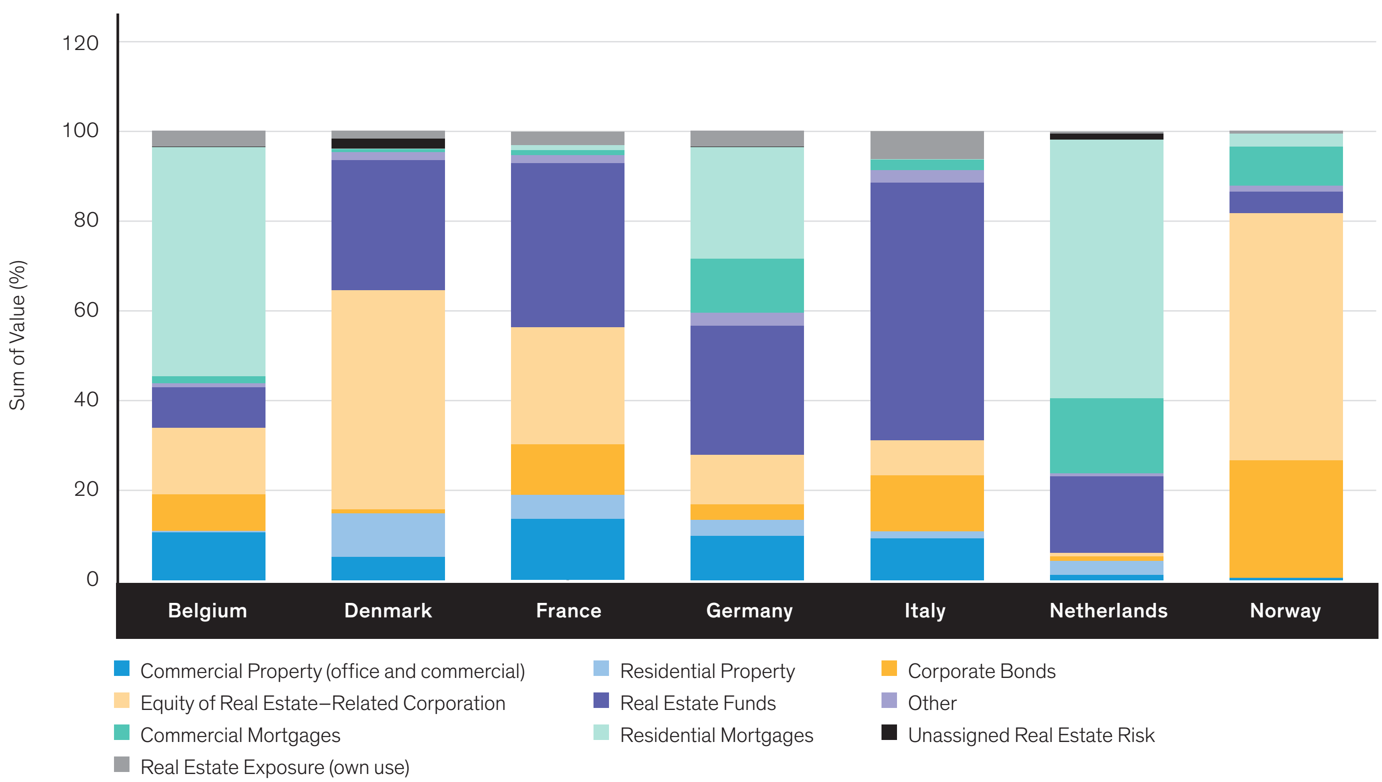
Time to Add Exposure?

What is generally driving insurers to consider commercial real estate exposure? Our conversations have revealed two primary motivations:

- Some are seeking **more efficient exposure**. In these cases, the insurer already has real estate allocations, usually through direct ownership of physical property. The current market backdrop has prompted many to explore whether there's a way to reallocate existing real estate exposure or deploy new money more effectively in another real estate–related asset class.
- Others are **revisiting their private market exposure**, which many have increased at the expense of public market holdings in recent years. Today's high interest-rate environment has some insurers asking whether the premiums they're generating from private assets are high enough to compensate for the liquidity they're sacrificing and wondering if there are better types of private asset exposure than those they currently have.

Let's start with the first group. Insurers have a long history of investing in real estate and underwriting property risk. And there are many ways in which they get that exposure today, including owning property outright, originating commercial real estate debt, investing in the corporate debt or equity of real estate companies, or through residential mortgages. But the current market environment is driving many to reassess whether their real estate exposure is fully compensating them for the risks to which they're exposed. While insurance investors have a wide range of real estate–related assets from which to choose, these assets' risk profiles and characteristics—and the reasons for holding them—can vary widely.

DISPLAY 3: EUROPEAN INSURER REAL ESTATE ALLOCATIONS



As of December 2022 | **Source:** European Insurance and Occupational Pensions Authority and AB

It may help to take a step back and look at European insurance companies' current exposure to real estate (*Display 3*). Preferences vary by country. Nordic investors have typically favored real estate equity, while Dutch insurers are large holders of local residential mortgages. French and Italian insurers are heavily invested in "real estate funds"—a somewhat nebulous classification in the European Insurance and Occupational Pensions Authority's (EIOPA) data in that it relates to an investment structure, not an asset class.

Solvency Efficiency: How Debt and Equity Stack Up

All these asset classes are related to real estate. But they are assessed under different modules of the European Union's Solvency II regulatory regime, which requires insurance companies to set aside an amount of capital sufficient to have a 99.5% confidence level that they would survive the most extreme expected loss scenario over the course of a year. There are stark differences in the way debt and equity are treated. These variations in solvency assessment highlight the variability in the actual risks associated with each type of real estate exposure.

Direct real estate carries a 25% Solvency Capital Requirement (SCR), or capital charge, under the property submodule, whereas developed-market equity carries a charge just above 38%.[4]

Within the debt sphere, both corporate bonds and commercial real estate debt will be treated under the spread risk module, though likely under different subsections. The capital charge for corporate bonds is a function of duration and credit rating. Commercial real estate debt, which is typically not rated by an external credit assessment institution (ECAI), carries a capital charge based on duration alone.

Residential mortgages—provided that they meet a range of criteria—are assessed outside the market risk module under the counterparty risk module. Their capital charge is prescribed as 15% of the Loss Given Default (LGD). The LGD is defined as the value of the loan less 80% of the risk-adjusted value of the property; further the risk-adjusted value of the property is taken as the market value with a 25% value stress applied. Resulting charges can range from 6% for 100% LTV ratios to 0% for loans with LTV ratios of 60% and below.

To gauge the solvency efficiency of each asset, we measure their expected yields (income) relative to the relevant capital charges. The former is the numerator in this equation and the latter the denominator. The higher the result, the more income generated for each unit of capital used.

How does commercial real estate measure up? Rather well, it turns out. Commercial real estate offers insurers a solvency efficiency ratio of more than 90%, well above that of all but one of the other types of real estate exposure (*Display 4*).

DISPLAY 4: SOLVENCY EFFICIENCY VARIES BY TYPE OF REAL ESTATE EXPOSURE

Asset Class	Approximate SCR	SII Module	Estimated Yield	Solvency Efficiency
Direct Real Estate	25%	Property Risk	6.0%	24%
Corporate Bonds (real estate–related corporations)	12.5%	Spread Risk	5.0%	41%
Equity of Real Estate Corporations	38%	Equity Risk	5.2%	14%
European Commercial Real Estate Debt	9.0%	Spread Risk—Unrated Debt	8.5%	94%
European Residential Mortgages	2.25%	Counterparty Risk	4.1%	182%

Corporate Bonds of real estate companies = Barclays Euro Aggregate, Financials, REITs at June 30, 2023; duration: five years; credit rating: BBB. Commercial Real Estate Debt assumed three-year duration and achievable yield as of June 30, 2023; Equity of Real Estate Corporates = FTSE EPRA NAREIT Europe as at May 31, 2023: Residential Mortgages = Simple average of Dutch, UK and German—five-year fixed rate, 75% LTV, June 30, 2023.

4 European Banking Authority, wwww.europa.eu

The exception? Residential mortgages, which win the solvency-efficiency sweepstakes hands down.

This is worth a closer look. Residential mortgages do well primarily because regulators guide insurers to assess these assets according to the counterparty risk module instead of the market risk one, which applies to the other forms of real estate exposure in our exercise.

Insurer holdings of these residential mortgage assets show some variation by country and are driven by specific market attributes and preferences:

- In the Netherlands, the National Mortgage Guarantee that covers over half of the residential mortgages in the market makes these assets an attractive investment for Dutch insurers, who play a more significant role in funding mortgages than their counterparts in other European countries (roughly 15%, according to the Dutch Central Bank, compared with 2.5%–5% for insurers in other European countries.
- Large UK insurers active in the Bulk Purchase Annuity space typically have significant exposure through Equity Release Mortgages and have set themselves up to originate, aggregate, securitize and add structural elements to ensure that pools of mortgages are eligible to be held within Matching Adjustment portfolios, which allow insurers to discount the valuation of their long-term liabilities at a more favorable discount rate than the usual risk-free rate. This is not an insignificant undertaking.

Moving in and out of residential mortgages, however, is not easy for insurance companies. Entering this market often calls for significant infrastructure and origination partnerships. This is why insurers' exposure beyond the UK and the Netherlands, has been limited.

Commercial real estate debt does not encounter these challenges. With its attractive yield and relatively low capital requirement, it represents a highly effective use of an insurer's solvency capital.

The Landscape for Asian Insurers

Various markets in Asia are moving toward or finalizing drafts of their own risk-based capital frameworks. This is likely to bring them closer in line to European insurers when it comes to embracing a detailed approach to solvency efficiency and asset-liability management.

Many regimes appear likely to be based on the International Association of Insurance Supervisors (IAIS) Insurance Capital Standard (ICS) 2.0 framework with slight variations to reflect local market features. Under ICS 2.0, the capital requirement for real estate debt can be treated in three ways:

- Derived as a function of loan-to-value (LTV) and debt service coverage ratio (DSCR)
- Derived as a function of LTV only
- Not based on LTV or DSCR

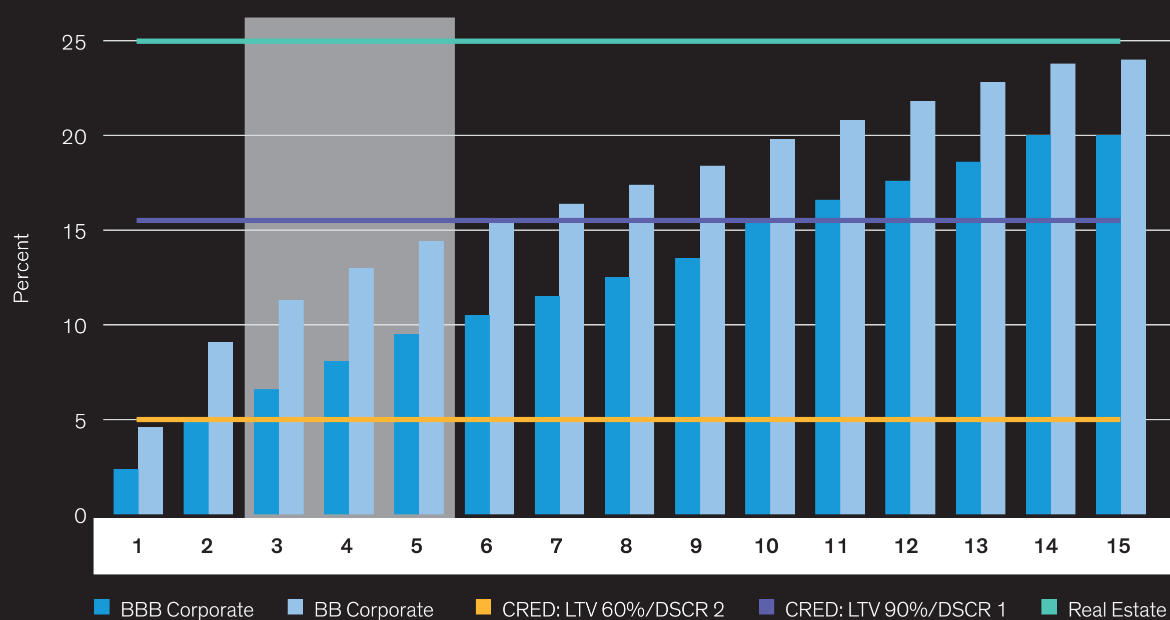
Compared to public corporate debt and direct real estate ownership, commercial real estate debt represents a highly efficient use of solvency capital in the region. Depending on LTV and DSCR, it carries an approximate capital charge of 5% to 15%. This encompasses all types of debt, from senior to mezzanine. One caveat: this does not include currency-hedging impacts, which vary over time and have in recent years been an important consideration for insurers when making asset allocation decisions.

Keep in mind that the capital charge for corporate bonds is based on duration and credit rating, with the blue first bar representing investment-grade debt and the second high-yield debt. Because commercial real estate and direct real estate are not rated, the capital charge is a function of duration alone and is measured by the horizontal lines.

Homing in on the 3-5 year duration segment, which accounts for the majority of commercial real estate debt (CRED) issuance, we see that conservatively underwritten CRED generates a lower capital requirement than BB- and indeed BBB-rated public bonds of the same duration. This suggests the asset class is likely to attract more attention from Asian insurers as they adjust to operating under risk-based capital solvency regimes.

HOW COMMERCIAL REAL ESTATE STACKS UP

ICS 2.0—Proposed Capital Charges



As of September 2023. | **Source:** IAIS Insurance Capital Standard 2.0, AB

DISPLAY 5: ONE SIZE WON'T FIT ALL—COMPARING REAL ESTATE RISK AND REWARD

Asset Class	Collateral	Ease of Market Access	Liquidity	Price Appreciation Potential	Inflation Hedge Potential
Direct Real Estate	N/A	Medium	Low	Yes	Higher
Corporate Bonds (real estate – related corporations)	No	High	Medium	Very Low	Lower
Equity, Real Estate Corporations	N/A	High	High	Yes	Higher
Commercial Real Estate Debt	Yes	Medium	Low	Very Low	Medium
Residential Mortgages	Yes	Low	Very Low	Very Low	Lower

As of September 2023 | **Source:** AB

A Word About Risk

Next, we consider the broader characteristics of each real estate-related asset class because where insurance investors choose to take their real estate risk will depend on more than income and capital adequacy requirements (*Display 5*).

In the current environment, the characteristics of real estate debt look particularly attractive. Loans at conservative LTV ratios can withstand a significant amount of property market stress before the value of the underlying collateral falls below the value of the loan. For an insurer who may have concerns about the real estate market outlook, these protections are very attractive. The benefit of collateral is also significant. Only commercial real estate debt and residential mortgages carry real estate collateral that can be seized should a borrower fail to keep up with payments or default outright.

Control is also an important consideration. In many other forms of lending, including through real estate bonds and even direct lending to companies, lenders are typically part of a large syndicate and must make decisions in concert with other lenders. Commercial real estate lenders typically have full control of all votes and decision making. That's important, because if something goes wrong, the lender doesn't have to build consensus with other members of the syndicate. Instead, it can be proactive in managing and protecting its capital.

This, along with the covenant protections in the commercial real estate market, allow debt managers to be active managers on behalf of investors.

The floating rate nature of real estate debt also provides an element of protection against inflation, an important current concern, as rate rises implemented to combat rising inflation will come through in the form of increased loan interest costs. The typically fixed-rate nature of corporate bonds and much of the residential mortgage market mean they afford less inflation protection.

Accessing the market isn't an easy or quick exercise. Laws across jurisdictions, origination capabilities and specialist knowledge of structuring arrangements vary. And it can take time to develop the sources necessary to find attractive deals. But neither is it a significant hurdle for insurers given their familiarity with this asset class and their ability to partner with asset managers who can source exposure to meet their requirements.

How insurers choose to invest in the sector will vary from investor to investor and be influenced by the primary objective each one is seeking to achieve. But we believe there's a compelling case to be made for private commercial real estate debt in today's market environment.

Public vs. Private Exposure

Finally, we'll look at whether commercial real estate debt offers an attractive yield premium relative to public market equivalents—and what that means for solvency efficiency.

In "Has the Market Reshuffled the Public-Private Mix for Insurers," we shared our thoughts on the public-private mix, highlighting three short- to medium-term considerations:

- Does the return potential of private assets still fully compensate me for any added risk?
- Does the specific private asset provide risk diversification and bolster my balance sheet?
- Do I still have capacity for illiquid assets today?

Having already addressed the risk characteristics of commercial real estate debt and given that insurers' capacity to take on illiquid assets varies, we'll refocus here on the first question. In *Display 6*, we measure the yield and spread of commercial real estate debt against investment-grade and high-yield corporate bonds of similar duration denominated in three different currencies—euros, sterling and dollars.

European Commercial Real Estate Debt carries a marginally higher solvency capital requirement than BBB-rated public corporate bonds but offers much higher yield and wider spread. It also offers a higher yield and spread than BB-rated bonds and a lower capital charge.

Recall, the capital charge for commercial real estate debt is a function of duration, as it's assessed as an unrated bond within the spread risk module. It's possible for commercial real estate debt to receive beneficial solvency capital treatment if the insurer opts to take credit for the collateral behind the loans. However, there is a series of criteria for the collateral to meet, including that there be no material positive correlation between the value of the collateral and the creditworthiness of the borrower. In practice, this is unlikely to be case. This is why, for the purposes of calculating solvency capital requirements, we assumed that no credit is taken for the collateral.

In *Display 7*, we translate these metrics into a solvency efficiency measure. As we are dealing solely with fixed-income investments, we calculate the spread/SCR ratio as well as the yield/SCR ratio to make it easier to isolate credit risk and control for minor differences in duration.

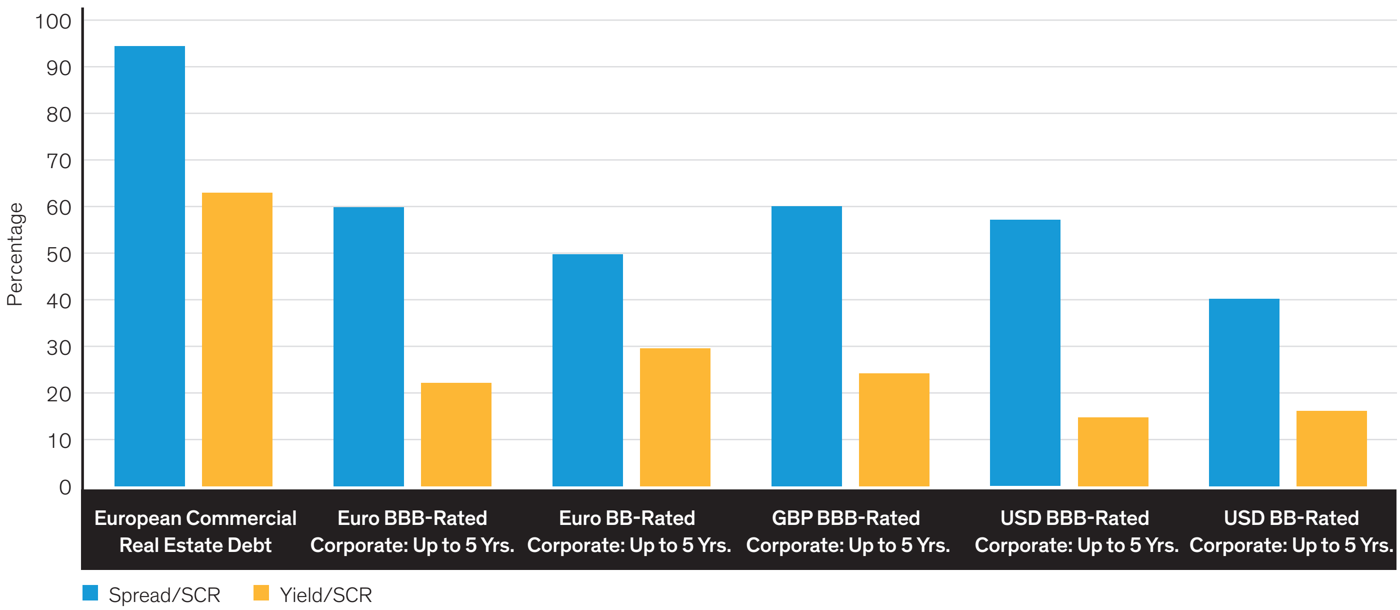
DISPLAY 6: COMMERCIAL REAL ESTATE DEBT VS. COMPARABLE CORPORATE DEBT

Asset Class	Yield	Eur Hedged Yield	Spread	SCR
European Commercial Real Estate Debt	8.50%	8.50%	567	9.0%
Euro BBB Rated Corporate: Up to Five Years	4.49%	4.49%	166	7.5%
Euro BB Rated Corporate: Up to Five Years	6.37%	6.37%	378	12.8%
GBP BBB Rated Corporate: Up to Five Years	6.73%	4.69%	189	7.8%
USD BBB Rated Corporate: Up to Five Years	5.73%	4.17%	108	7.3%
USD BB Rated Corporate: Up to Five Years	6.98%	5.59%	225	13.9%

As of July 2023 | **Source:** Barclays, EIOPA and AB

DISPLAY 7: MEASURING SOLVENCY EFFICIENCY

Solvency Efficiency of European Commercial Real Estate Lending



As of July 2023 | **Source:** Barclays, EIOPA and AB

On both metrics, commercial real estate debt looks more attractive than public corporate debt with equivalent rating and duration.

But leaving rating and duration aside, insurers will reasonably ask whether they are taking on any additional risks and whether they're being fully compensated. A formulaic attribution of return by risk driver is not feasible here. But the obvious remaining risk varies based on liquidity.

Yields on European commercial real estate debt range anywhere from 1% to 3% higher than those on the public alternatives considered here. In our experience that will meet or exceed the hurdles that most insurers have set for an "illiquidity premium" when moving from public markets to private ones.

In this context, we believe the returns of commercial real estate debt offer an attractive way to increase private market exposure for insurers with the liquidity capacity and appetite to do so. In our view, what investors lose in liquidity they make up for in return potential and greater control over the loan—an important feature should borrowers run into trouble.

Summary

Private lenders are rapidly displacing banks when it comes to financing commercial real estate. And as banks retreat, the balance of power has shifted from borrowers to lenders, who in today's tight credit conditions can originate loans to quality borrowers at low loan-to-value ratios and high spreads, making these assets highly attractive for institutional investors.

We believe that insurers are in a prime position to take advantage of this structural market shift. The most attractive opportunities may be available in Europe, where banks' retreat from the market is accelerating. A higher allocation to commercial real estate debt may be an effective way for insurers to maintain exposure to real estate as an asset class more broadly.

It's also likely to deliver higher returns than public market options with a similar risk profile and provide strong downside protection potential, giving insurance companies an opportunity to make efficient use of their market risk solvency budgets.

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