# Global Insurance Market Opportunities

## The evolution of real estate and real assets investment by insurers

By Gerard-Jan van Berckel

### About the GIMO

Since its launch in September 2015, the Global Insurance Market Opportunities report has quickly become a leading thought leadership study and reference document for the re/insurance industry.

In 2018, we are taking a new approach to its distribution by publishing articles throughout the year under the banner of Global Insurance Market Opportunities, rather than launching the single, comprehensive report. In so doing, we aim to increase its utilization, bring our ideas to market as fast as possible to support further development with our re/insurance client partners, and make it easier for GIMO readers to digest the wealth of content generated annually.

For centuries, insurance companies worldwide have been underwriting property risk. What we recognize as property insurance was developed primarily in England after the Great Fire of London in 1666. The U.S. developed the property-casualty insurance market with the first U.S. fire insurer established by Benjamin Franklin in 1752.

Insurance companies have an interesting history in relation to property insurance – in fact, they were the first firefighters. They ran fire brigades in their early days and even after firefighting became the responsibility of local governments, the industry still played an active role Insurance companies created the National Fire Protection Association in 1896, which remains the world's leading advocate of fire prevention and public safety.

Throughout history insurers have been a safety beacon for governments, corporations, and individuals owning and leasing property. Insurance companies have taken good care of the premium they received and invested prudently in high-quality assets.

Today, these close ties between insurers and property continue as insurers invest in real estate – whether equity or debt – and make informed investment decisions to maximize their own portfolio yields. For many years, eligible public bonds, often secured by real assets such as real estate itself, have been a staple of insurance company investment portfolios.

> The investment opportunity presented by the real estate debt market is significant, with nearly £1000bn of debt available in Europe alone

However, as capital markets have proven increasingly hard to navigate, especially over the last decade, insurers have explored new approaches to maintain their investment returns and diversify their risk by considering new asset classes both in the U.S. and Europe. We have seen European insurers grow increasingly interested in the possibilities that real assets have to offer such as direct and indirect real estate debt and infrastructure debt – investing by making secured loans to an owner or purchaser of these assets. Insurers understand that investing in these assets can enhance the performance of their portfolios. This is something that has been common practice for U.S. insurers since the 1990's.

These assets are illiquid compared to bonds and sound origination can also be a challenge. Further, regulations vary and obtaining favorable capital treatment by insurers means satisfying a variety of rules for each of these real asset classes.

## How can insurers use real estate debt investing to their advantage?

Investment grade real estate debt can be an attractive asset class for insurers as it offers:

- Higher rates of return than public debt that is more capital-efficient
- Higher recovery rates than corporate bonds where investments are secured against a named asset with the investor having greater control
- Post financial crisis, higher margins than previously existed
- Lower loan-to-value levels further increasing the attractiveness of the assets

So insurers who are able to increase allocations to real estate debt can enjoy favorable returns compared to similar assets – and while not taking on additional credit risk. Often, insurers have capacity to take on liquidity risk, particularly those insurers with liability profiles that exceed five years. The combination of an ability to take on liquidity risk and the favorable returns and risk characteristics of real estate debt means insurers can use this asset class to improve their returns on capital.

## Why is real estate debt of growing interest to insurer investors?

Insurance companies worldwide predominantly invest in debt instruments, with allocations to various fixed income asset classes typically representing all or a vast majority of invested assets for insurers.

As part of these fixed income allocations, and as this asset class typically benefits from outperforming other assets in inflationary times, insurers have begun to allocate increasing amounts to loans linked to real estate and other 'real' or physical assets ranging from property to infrastructure projects.

When we explore why investment in commercial real estate debt is increasing and expected to continue growing in future, we see several drivers:

- Low yields and compressed spreads in public bond markets, alongside favorable regulatory treatment for insurers, make real estate debt attractive as an alternative to public bonds.
- The relative pricing advantage of these assets is unlikely to deteriorate; demand for debt continues and banks remain unlikely to increase lending due to capital constraints. Basel III capital requirements for debt, along with other regulatory requirements, mean traditional real estate lenders are exiting the market, resulting in an excess demand over supply of loans. While the UK is showing most evidence of this, a similar if more embryonic situation is evident in Europe, with Australia and Asia-Pacific showing comparable patterns.
- Under Solvency II regulation, insurers have an incentive to lend against real estate and real assets, rather than own it direct. Capital charges are lower for debt than equity and – given the relatively high yields currently available – debt remains more attractive to insurers looking to maximize risk adjusted returns on capital.

## A large and growing opportunity

Traditionally, life insurers target longer duration assets, in excess of seven years, while property-casualty insurers tend to focus on short duration investments due to their liabilities. Changes in regulation over the last five years have seen Periodic Payment Order liabilities for property-casualty insurers become more pronounced. Many property-casualty insurers see investment in real estate debt as a preferred solution to tackle longer-term liabilities, making real estate debt an increasingly suitable investment for all types of insurers that have to mitigate the duration gap.

Insurers, as with several real assets, need to consider the regulatory frameworks in which they operate, such as Solvency II for Europe or Risk Based Capital in the U.S. As regulation changes and evolves real assets, real estate debt investments, infrastructure and co-investment strategies have proven to become a resilient cornerstone of an insurer's investment portfolio.

Importantly for insurers, the market is large and with banks exiting, not likely to become smaller. In Europe alone, outstanding commercial real estate debt exceeded EUR978bn at the end of 2014, with the amount of outstanding debt in the UK alone exceeding GBP160bn today, according to the UK Commercial Property Lending Report H1 2017, produced by De Montfort University.

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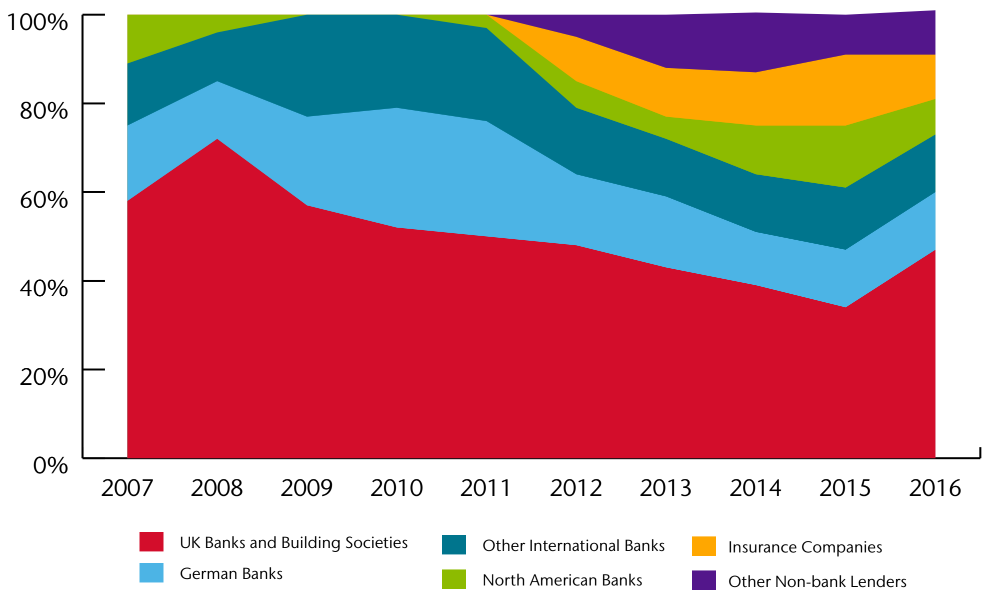
Allocation of outstanding debt secured by commercial property by catergory of lender




Source: UK Commercial Property Lending Market Research Findings 2016 Year End (De Montfort University) - Allocation of new origination since 1999

## The challenges of investing in real estate debt

Insurance and reinsurance investors realize the advantages of investing in real estate debt. There are potential pitfalls to avoid and regulatory requirements to be met.

Key challenges we have identified include:

1. Lack of specialist knowledge. Although many insurers underwrite property risk, investing in this asset class does require an in-depth knowledge. Many insurers do not have in-depth knowledge of how to invest in these assets, or their knowledge is limited to their own domestic market. Much of the knowledge has traditionally been housed in banks and now increasingly sits within asset managers.
2. Having access to deal flow and origination of attractive real asset opportunities can often only be found by dedicated managers and advisors with established teams and track records.
3. Many insurers are seeking broader market exposure than has historically been available via third-party managers – in terms of both sector and geography. Many third-party managers, particularly in Europe, have typically been boutique, focusing only on certain sectors of the market or specific regions.
4. Many investors' capital constraints have led to them seeking co-investment capabilities, which have been in short supply up to now.

Today, with the clear and growing appetite for real estate debt investment, these challenges are being addressed. Solutions are being devised whereby third-party experts can help insurers and reinsurers to invest in their desired asset classes.

By delegating day-to-day investment and governance to an experienced team of investment and regulatory experts, insurance Chief Investment Officers can be confident that their requirements are being handled by professionals. The legal and operational support needed can be provided alongside the investment expertise, giving insurer investors assurance that their approach is both effective and compliant.

The creation of real assets, real estate, and private debt fund investment opportunities will enable growing numbers of insurance and reinsurance investors to tap into their potential. Co-investment capabilities are being developed that help investors to overcome capital constraints while the delegated investment options enable insurers to realize the benefits of untapped asset classes in a compliant and efficient way.

We expect the market for real estate and private debt investment to grow exponentially over the coming years, with the potential for investors to benefit increasing in tandem.

## About the Author:

Gerard-Jan van Berckel has over 20 years' experience of working with institutional investors, such as banks, pension schemes and insurance companies, across Europe; he is one of the pioneers of fiduciary management. Before joining Aon, he worked at Rogge Global Partners (RGP) where he was head of insurance and northern Europe distribution. Prior to this, he was head of Continental European sales for Swiss Re / Conning Asset Management. Today, Gerard-Jan leads Aon's delegated investment activities with insurance companies across the UK and Europe. He works with actuarial and risk & capital management colleagues to provide the full range of capital and investment management solutions, optimising capital for insurers and reinsurers EMEA-wide.

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