NAIC National Association of Insurance Commissioners & The Center for Insurance Policy and Research

Capital Markets Special Report

The NAIC's Capital Markets Bureau monitors developments in the capital markets globally and analyzes their potential impact on the investment portfolios of US insurance companies. A list of archived Capital Markets Bureau Special Reports is available via the index

A Perspective on U.S. Insurers' Mortgage and Unaffiliated Real Estate Investments as of Year-End 2015

In this special report, we discuss U.S. insurer's reported investments in mortgage loans and unaffiliated real estate (RE) for year-end 2015, as reported in Schedules B (Mortgage Loans), A (Real Estate), and BA (Other Long Term Invested Assets). Our analysis focuses on the distribution and concentrations of these investments among property types and geographical markets. We also consider current conditions and the outlook for the commercial mortgage market. Additional disclosure for property types was required for U.S. insurers' reporting in 2014 and 2015, allowing for more extensive analysis of property types on an industry wide basis.

U.S. Insurer Holdings

U.S. insurers' have invested an average of 7% of their total cash and invested assets in (at least) the last six reporting years in mortgage loans and unaffiliated real estate assets (Table 1). Since year-end 2010, these assets have increased year-over-year by $114 billion (on an aggregate basis), or by 32%. The largest asset type held, as measured by book/adjusted carrying value (BACV), has been in commercial mortgage loans that are in good standing (that is, all of the basic terms of the loans are being met by the borrowers). Life companies have consistently held the majority of mortgages and unaffiliated real estate reported each year.

Table 1: Mortgage & Real Estate Investments, $ Mil. BACV, Year-End 2010 - 2015

	Real Estate	Mortgage Loans	Mortgage & Unaffiliated Real Estate Assets (Reported in Other L-T Assets)	Total	% of Total Cash & Invested Assets
2015	$ 21,681	$ 427,639	$ 16,506	$ 465,826	8%
2014	$ 18,551	$ 393,686	$ 17,607	$ 429,845	7%
2013	$ 18,896	$ 371,774	$ 17,010	$ 407,680	7%
2012	$ 17,941	$ 351,760	$ 16,473	$ 386,174	7%
2011	$ 16,992	$ 339,011	$ 15,890	$ 371,892	7%
2010	$ 15,804	$ 323,132	$ 13,116	$ 352,051	7%

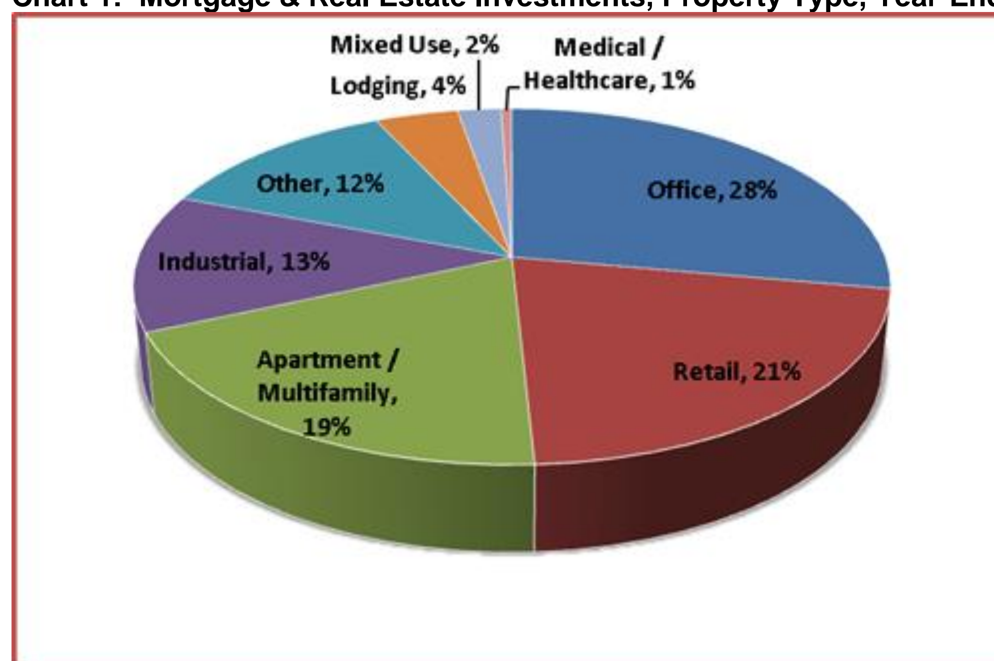
U.S. insurance companies reported total BACV of $466 billion in mortgage loans and unaffiliated RE investments for year-end 2015, or about 8% of total cash and invested assets. The allocations, by insurer statement type and by reporting schedules, are shown in Table 2. Mortgage loans constituted the largest share of these assets, accounting for 92% of the combined BACV total. Life insurers were the largest holders, with $433 billion or 93% of the total as of year-end.

Table 2: Mortgage & Real Estate Investments, $ Mil. BACV, as of Year-End 2015

Schedule	Investment Type	Life	PC	Fraternal	Title	Health	Total	% of Total
B	Mortgage Loans	$ 404,468	$ 12,485	$ 10,639	$ 10	$ 37	$427,639	92%
A	Real Estate	$ 18,285	$ 2,981	$ 124	$ 50	$ 241	$ 21,681	5%
BA	Mortgage & Real Estate Assets Reported in Other Long Term Invested Assets	$ 10,339	$ 5,224	$ 236	$ 650	$ 57	$ 16,506	4%
Total		**$ 433,092**	**$ 20,690**	**$ 10,998**	**$ 901**	**$ 144**	**$ 465,826**	
% of Total		93%	4%	2%	0%	0%		

Insurers' holdings in mortgages and RE were spread across multiple property types, as shown in Chart 1 below. The largest exposures were in office, retail, and apartment/multifamily properties, and to a lesser degree, in industrial and in the 'other' category (which captures other property types such as land, parking garages, warehouses, etc.). Insurers had a relatively minor exposure to lodging, mixed use, and medical/health care properties.

Chart 1: Mortgage & Real Estate Investments, Property Type, Year-End 2015



Domestic and Foreign Exposure

Insurer investments in commercial loans and unaffiliated RE properties located within the U.S. accounted for $447 billion at year-end 2015; loans and RE investments in properties outside the U.S. represented approximately $16 billion, or 3% of the total. In terms of BACV distribution among property type, U.S. insurers had their largest investment in office and retail space both domestically and abroad. A full breakdown of holdings between property types is provided in Table 3 below.

Table 3: Mortgage & Real Estate Investments, Domestic & Foreign, $ Mil. BACV, Year-End 2015

	Office	Retail	Apartment / Multifamily	Industrial	Other	Lodging	Mixed Use	Medical / Healthcare	Total
U.S.	$ 123,661	$ 96,649	$ 87,121	$ 55,374	$ 54,339	$ 17,657	$ 9,669	$ 2,423	$ 446,893
% of Total	28%	22%	19%	12%	12%	4%	2%	1%	100%
	Office	Retail	Other	Industrial	Apartment / Multifamily	Lodging	Mixed Use	Medical / Healthcare	Total
Non-U.S.	$ 5,259	$ 2,336	$ 2,321	$ 2,291	$ 1,724	$ 1,584	$ 422	$ 1	$ 15,938
% of Total	33%	15%	15%	14%	11%	10%	3%	0%	100%

Domestic Mortgage Loan and Unaffiliated RE

Forty-eight percent of the U.S. insurance industry's domestic mortgage loan and unaffiliated RE exposure, with a BACV of $223 billion, was allocated across five states. California accounted for the largest single state exposure, at 21% of total BACV. The other states were New York and Texas, each with approximately 9% of the total, while Florida and Illinois had close to 5% each. Altogether ten states accounted for 66% of total mortgage loan and unaffiliated RE exposure at year-end 2015.

Property type distribution among the top five states varied. In California, for example, 28% of reported BACV was in office properties; in New York, office space was 45% of the total; and in Florida it was 12%. Table 4 below details each of the five states' reported BACV distribution across property types at year-end 2015.Within California, insurer investments were most concentrated in San Francisco (8%), Los Angeles (8%), and San Diego (7%). In New York, exposure was mostly concentrated in New York City (73%); in Texas, it was in Houston (29%) and Dallas (15%); in Florida, Orlando and Miami (11% each); and in Illinois, Chicago (52%).

Table 4: Top Five State Exposures – Property Type Distribution, $ Mil. BACV, Year-End 2015

State	Office	Retail	Apartment/ Multifamily	Industrial	Other	Lodging	Mixed Use	Medical/ Healthcare	Grand Total
California	$ 25,798	$ 17,956	$ 15,368	$ 14,505	$ 12,962	$ 4,165	$ 1,803	$ 501	$ 93,059
	28%	19%	17%	16%	14%	4%	2%	1%	100%
New York	$ 19,144	$ 7,019	$ 9,095	$ 1,029	$ 2,976	$ 1,897	$ 1,115	$ 87	$ 42,362
	45%	17%	21%	2%	7%	4%	3%	0%	100%
Texas	$ 11,353	$ 9,039	$ 8,703	$ 5,109	$ 4,142	$ 1,032	$ 395	$ 268	$ 40,040
	28%	23%	22%	13%	10%	3%	1%	1%	100%
Florida	$ 2,940	$ 7,432	$ 4,382	$ 2,754	$ 4,311	$ 1,840	$ 321	$ 130	$ 24,110
	12%	31%	18%	11%	18%	8%	1%	1%	100%
Illinois	$ 7,626	$ 4,520	$ 4,123	$ 2,820	$ 2,835	$ 558	$ 580	$ 48	$ 23,111
	33%	20%	18%	12%	12%	2%	3%	0%	100%
Grand Total	$ 66,860	$ 45,966	$ 41,670	$ 26,218	$ 27,227	$ 9,492	$ 4,215	$ 1,034	$ 222,682
	30%	21%	19%	12%	12%	4%	2%	0%	100%

ForeignMortgage Loan and Unaffiliated RE

Insurers reported a BACV of approximately $16 billion in mortgage loans and unaffiliated RE for properties located across 27 countries outside the U.S. Note that this represents a small percentage, or 3%, of the industry's total mortgage loan and unaffiliated RE exposure. In addition, over 94%, or $14 billion of these loans, was in mortgages in good standing.

Great Britain accounted for 58% of that total, followed by Canada with 12%, Mexico with 10%, and Brazil with 5%. Thirty-four percent of total foreign BACV was in office properties, 15% in 'other', 13% each in retail and industrial, 11% in apartment/multifamily, 11% in lodging, and 3% in mixed use. Within Great Britain, properties in the London area comprised over 81% of the country's BACV share and office space was the predominant property type (at 43%), distantly followed by apartment/multifamily (18%).

Following the Brexit vote, some asset managers suspended trading in commercial-property funds due to lack of liquidity and/or a high level of redemptions because of uncertainty surrounding Brexit's potential market impact. In addition, industry analysts have commented that they expect London office values in particular to drop as much as 20% within three years of the U.K.'s exit from the European Union (EU); concern is mitigated by the U.S. insurance industry's relatively small exposure to U.K. mortgage loans and unaffiliated RE.

Quality of Mortgage Loans

Almost all U.S. insurer investments in mortgage loans, or $425 billion of the $431 billion total, were in mortgages reported in good standing. Within that subset, commercial mortgages represented the largest share, or $385 billion, followed by farm mortgages at $18 billion, residential mortgage at $11 billion, and mezzanine loans at nearly $9 billion. Insured or guaranteed residential and commercial loans and 'other' accounted for the balance.

Compromised mortgage loans, or those that were either restructured, had interest that was overdue beyond 90 days but were not in foreclosure, or were in the process of foreclosure, were relatively minimal, at slightly over $2 billion.

Note that the NAIC's current framework for assessing risk-based capital (RBC) for commercial mortgages held by life companies captures differences in loan characteristics and adjusts RBC requirements accordingly. The current process, which replaced the mortgage experience adjustment factor (MEAF), is 'risk-focused' and objectively evaluates the risk level of individual commercial mortgages by relying on debt service coverage and adjusted loan-to-value calculations to determine appropriate capital charges.

Performance in the U.S. Commercial Real Estate Market

The commercial real estate market is moved by a confluence of forces, key among them is the health of the general economy, market supply and demand dynamics, vacancy and rent trends, and level and changes in activity in the related capital markets. The state of the economy, for example, determines the level of financial activities and the level of employment, two important drivers for demand for office space. The capital markets environment, alternatively, drives levels of acquisition, investment, lending, cap rates, and foreign buying of commercial real estate.

The office property market (28% of insurers' U.S. mortgage loans and RE in 2015) has strengthened since the beginning of the year as office-using employment increased, the national vacancy rate declined, absorption rebounded, overall gross asking rent increased and office investment remained high. The growth in office-using job growth, per CBRE Inc. (a RE services and investment firm), has been led by demand from the tech markets and in metros in the south and west. Growth within this market was expected to moderate over the near term on slower office-using employment growth, demand, and rent growth.

In the top office metro markets (i.e. Manhattan, Los Angeles County, Washington, Chicago, Atlanta, San Francisco, Dallas, Boston, Seattle, and Houston), as tracked by commercial real estate firm Colliers International, absorption increased in the second quarter of 2016 in nine of the ten markets and asking rents continued to rise in the core areas in eight of the ten markets. Competition for 'creative-type office space', that is, a more open floor plan with fewer offices and shared workspaces, from new tech firms had pushed asking rents higher.

Fundamentals in the U.S. retail property market (22% of insurers' U.S. mortgage loans and RE in 2015) improved relative to the first half of 2016 on stronger consumer spending, firmer demand, accelerating rents, and tighter availability rates. CBRE expects continued improvement in consumer confidence, on the heels of a healthy labor market and wage and income gains, to sustain the momentum in this market for the remainder of 2016.

Conditions in the multifamily property market (20% of related insurer exposure), according to CBRE, have been healthy for the last seven years with 'both cyclical and structural trends' supporting strong market demand. They believe, however, that this market is moving into a new phase where construction deliveries are outpacing demand which will restrain performance for the balance of 2016.

The U.S. industrial market (12% of related insurer exposure) remained strong in the second quarter with demand still exceeding supply. The vacancy rate in this market was down to its lowest point since 2002 and net absorption, per CBRE, below new supply for the 24th consecutive quarter. CBRE's outlook is for little change in dynamics or 'much of the same'.

Pricing

Moody's/RCA Commercial Property Price Indices (CPPI; a national all-property composite index which measures price changes in US commercial real estate based on completed sales of the same commercial properties over time) increased in each of the 1, 3, and 12-month periods ending August 2016 on gains in prices in both the apartment and core commercial sectors (see Table 5). Apartment/multifamily building prices have expanded at a much faster rate than core commercial prices in each of these periods. On a year-over-year comparison, price gain for the apartment/multifamily sector was unchanged at 14%. For the core commercial sector, however, price growth slowed dramatically, going from 16% last year to just 6% this year as a result of slower growth across all component property types.

By market type, the best performer was the central business office market, where prices ticked up by 8% for the 3-month period and by 2% in the month of August. Major markets, which cover Boston, Chicago, Los Angeles, New York, San Francisco, and Washington, D.C., experienced stronger price growth than non-major markets with 6% versus 2% over the three-month period and 2% compared to less than 0.6%.

Table 5: Commercial Property Price Growth

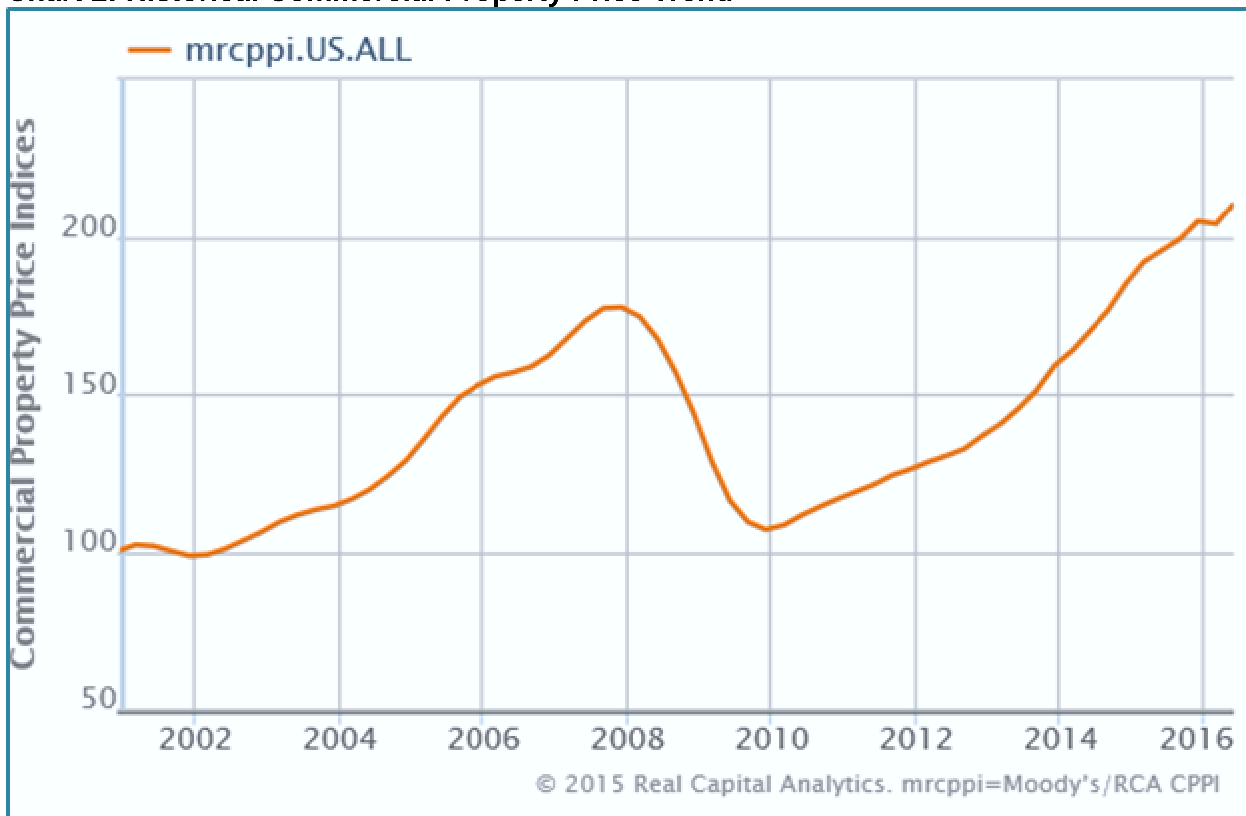
Moody's/RCA Commercial Property Price Indices
Price Changes by Sector and Market Type
Value-Weighted Composite Tiers

	Aug-16	Aug-15	3 Month-Aug16	3 Month-Aug15	12 Month-Aug16	12 Month-Aug15
National All-Property	1.1%	1.6%	3.7%	3.0%	8.2%	15.2%
Sector:						
Apartment	1.3%	1.3%	4.5%	2.4%	14.3%	14.2%
Core Commercial	1.0%	1.8%	3.4%	3.2%	5.7%	15.6%
Market Type:						
Retail	0.2%	0.2%	0.8%	1.4%	6.7%	10.7%
Industrial	-0.2%	2.6%	2.7%	1.8%	8.1%	12.5%
Office (central business district)	2.4%	2.6%	7.9%	6.3%	4.6%	24.1%
Office Sububan	1.6%	1.7%	2.3%	3.0%	3.9%	14.1%
Major Markets	1.7%	2.2%	6.0%	4.5%	9.4%	17.9%
Non-Major Markets	0.6%	1.1%	1.7%	1.6%	7.1%	12.9%

Source: Moody's Investors Service.

Chart 2 provides a historical snapshot of Moody's CPPI national all-property composite index since its inception in Dec. 2000. Since its establishment, the index has recorded a long-term cumulative appreciation of 114.5%. At its most recent value of 214.49 (through Aug. 2016), it had increased by 21% above a pre-crisis peak of 177.78 in Nov. 2007, and it more than doubled from the 106.86 post-crisis trough in Jan. 2010.

Chart 2: Historical Commercial Property Price Trend



Source: Real Capital Analytics

Originations

According to the Mortgage Bankers Association (MBA) Quarterly Survey of Commercial/Multifamily Mortgage Bankers Originations of Q3 2016, loan originations increased by 2% in the first nine months of 2016 over the same period in 2015. In comparison, there was a 27% increase in the first nine months of 2015 over the same period of the prior year. Originations for bank balance sheets increased by 19%, by 13% for Fannie Mae/Freddie Mac, and 3% for life insurance companies. That is, however, below the 2015 record levels of 49% for banks, 85% for Fannie Mae/Freddie Mac, and 25% for life companies. Year-over-year dollar volume of loans in the third quarter, for industrial and multifamily properties, increased by 32% and 26%, respectively. This was coupled with decreases for office (5%), retail (23%), hotel (30%), and health care (59%) property loans.

Originations for commercial mortgage-backed securities (CMBS) were down by 20% for the nine months ending Sept. 2016 relative to same period last year. This was despite a 96% pick-up in the third quarter of 2016 and also represented a decrease from a 9% growth rate in 2015. The CMBS market, according to MBA, has been rebounding since 2009, when issuance fell to $11 billion from its pre-financial crisis level of $241 billion in 2007. At year-end 2015, CMBS new issuance had reached $94 billion based on MBA data.

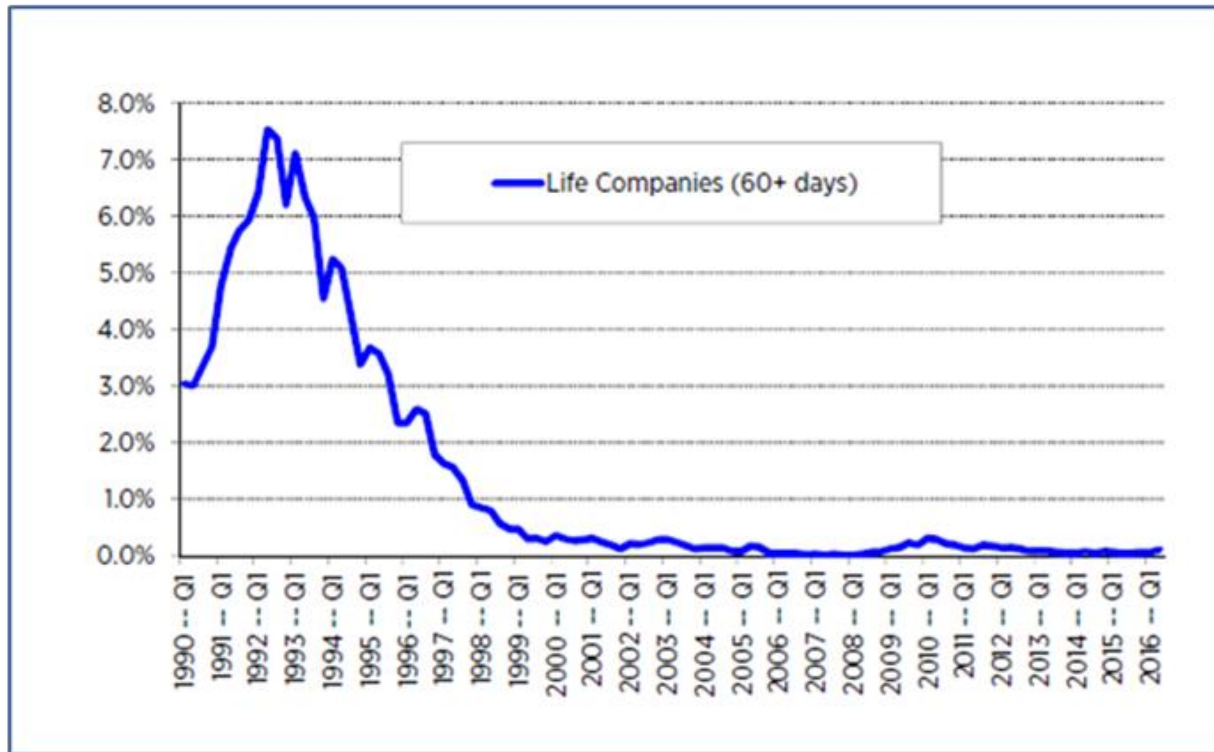
The dollar volume of loans originated for Fannie Mae and Freddie Mac was up by 82% year-over-year but had decreased for life insurance company loans by 3%, for Commercial Mortgage backed Securities loans by 4%, and for commercial bank portfolio loans by 9%.

Delinquencies

MBA reported that delinquency rates (based on the unpaid principal balance of loans) for commercial and multifamily mortgage loans remained low in the second quarter of 2016, and for most capital sources, near the lowest levels of the past 20 years.

Delinquency rates within life company portfolios rose to 0.11% in the second quarter, up from 0.06% in the prior quarter and were unchanged from fourth quarter 2015. Delinquency rates, however, have historically been below 1% since 1998 (Chart 3). At year-end 2015, BACV of $2.3 billion was reported for mortgages with overdue interest or in foreclosure, and delinquent mortgages totaled only $137 million in BACV at year-end 2015 (relative to a total of $428 billion for all mortgages held).

Chart 3: Historical Delinquency Rates, Life Companies



Source: MBA

Changes in delinquency rates for life companies along with other large investor groups, who together hold more than 80% of commercial/multifamily mortgage debt outstanding, are shown in Table 6. Quarter to quarter developments showed marginal improvements in rates for banks, thrifts and Freddie Mac, but an uptick in delinquency rates for CMBS. According to MBA, the ‘extremely’ low level of delinquencies continues to be supported by ‘strong property fundamentals, rising property values and solid mortgage availability.’ Although CMBS delinquencies were up slightly in the second quarter of 2016, this increase followed a record decrease in the first quarter, and was an improvement from the 5.2% in the first quarter of 2015.

Table 6: Delinquency Rates, Commercial/Multifamily Mortgage Loans (Based on Unpaid Principal)

Investors		1Q 2016	2Q 2016
Banks and thrifts	≥ 90 days or in non-accrual	0.73%	0.66%
Life company portfolios	≥ 60 days	0.06%	0.11%
Fannie Mae	≥ 60 days	0.06%	0.07%
Freddie Mac	≥ 60 days	0.04%	0.02%
CMBS	≥ 30 days or in REO	3.93%	4.04%

Source: MBA; REO (real estate owned) refers to foreclosed-upon real estate.

Outlook for Commercial Lending

CBRE was 'cautiously optimistic' about the commercial lending markets in the second half of 2016, indicating that there is potential for "additional volatility" from a Federal Reserve interest rate hike, the high level of loan maturities in the CMBS market, and the effects of new regulations (the Dodd-Frank Act requiring CMBS originating lenders to retain some of the loan risks). MBA also expects that "low interest rates combined with strong commercial property market fundamentals to further support lending and to keep overall borrowing levels on pace with last year's strong level".

Conclusion

U.S. insurers' investments in mortgage loans and unaffiliated RE at year-end 2015 were predominantly in loans in good standing with just marginal exposure to compromised loans, lending comfort to any concerns regarding timely payment (principal and interest) on the loans and RE. Insurers were not exceedingly concentrated in any one single property type, thereby adding the benefit of market diversification. Any concentration of properties in certain cities and states were in major core U.S. markets.

For mortgage loans and unaffiliated RE in properties outside the U.S., insurer exposure at year-end 2015 was limited to just 3% of total BACV. Insurers, however, had 58% of their foreign mortgage loans and unaffiliated RE in the U.K., largely in the London area. The U.K. property market, after the Brexit vote in June 2016, was unsettled by the uncertainty over the economic future of the U.K. and the EU trade relationship. Investors in U.K. commercial property funds reportedly pulled out £1.4 billion in June in reaction to Brexit fears and in spite of trading suspension by some large commercial real-estate funds.

Moody's considered the Brexit vote a credit negative for the U.K.'s commercial real estate market and estimated that average prices could decline by as much as 10%. Fitch Ratings also viewed the vote as a challenge to market fundamentals as a result of 'delays in investment decisions and increased property risk premiums'. For U.S. insurers, if weakness in the British pound (which was driven down by the Brexit vote) continues through year-end 2016, it could potentially lead to lower reported BACV for U.K. property holdings due to adjustments to book values from unrealized foreign exchange losses.

Performance across U.S. commercial real estate markets, in general, has improved since the beginning of 2016, supported by stable or strengthening market fundamentals. Near term expectations are for fundamentals to stay positive at least through 2016 as new supply growth remains limited in many sectors and certain cities. There are some concerns, however, that the industry might be moving closer to the end of the current expansion cycle.

Lastly, there is also some uncertainty regarding what a Donald Trump presidency will mean for the commercial real estate industry. Early speculations are that the market could benefit from a president whose business has been primarily in commercial real estate, and who may perhaps, entertain more favorable tax rates and/or legislation for the real estate market.

The Capital Markets Bureau will continue to monitor developments within the mortgage loan and unaffiliated RE markets and report as deemed appropriate.

Questions and comments are always welcome. Please contact the Capital Markets Bureau at **CapitalMarkets@naic.org**.

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