Commercial real estate debt
An interesting proposition for European insurers
Introduction

In the years following the global financial crisis, the commercial real estate (CRE) debt market has changed dramatically, both in the character and the availability of CRE debt. The hunt for yield has led insurance companies to consider more illiquid assets, such as secured CRE debt, which were formerly concentrated in the banking sector. Regulatory changes in the banking world and the economic impact of low interest rates created a wealth of opportunity for insurers in alternative asset classes. Attractive spreads, capital efficiency and the promise of greater security make CRE debt a prime target as an asset class: both to match long-term liabilities (annuities and participating business) through longer-dated CRE debt, and also as investments for short-term investors such as general insurers and shareholder funds, through shorter-dated CRE debt. But, did the insurance industry wake up too late to this attractive opportunity?

The focus of our discussion is on the CRE debt market in the UK. Over the past three years, insurers have noticeably moved into non-traditional illiquid asset classes to optimize their balance sheets. Shifting regulation (i.e., relaxation of asset admissibility rules) and the ongoing hunt for yield are key drivers of this change.

UK insurers have committed more than £25 billion to infrastructure projects in the UK alone. CRE debt has been part of that insurance investment, with large players like Guardian, Friends Life and Standard Life publicly entering into sizeable CRE debt mandates in recent years.

But the rising attractiveness of CRE debt might be diminishing: spreads have narrowed over the last 18 months (illustrated in figure 1) as insurers, among other investors, jump in to get their slice of rare, prime commercial property debt. (The reduction in volume of CRE loan books in the UK market is shown in figure 2).

In this paper, we consider the current appeal of CRE as an illiquid asset class to back insurance liabilities.

Figure 1. Average interest rate margins by sector, 1999-2013


Figure 2. Net aggregated value of UK commercial property loan books, 1999-2013

Why insurers invest in illiquid assets

Other factors have led insurers to consider CRE debt as an investment option:

- The financial crisis and the introduction of a more stringent Basel III regulatory environment have led to a partial withdrawal of bank funding for real estate, especially longer-duration facilities. However, this decline has not been met by a consequential fall in demand for real estate funding, and has created a funding gap, temporarily driving up spreads on prime CRE loans (see figure 1 on page 3).

- The security structure of CRE debt is particularly attractive for insurers and typically includes:
  - A legal charge on the underlying property
  - A legal right to protect the property from being assigned elsewhere without the consultation and approval from debt providers
  - The cash flow pattern of CRE debt, especially if originated directly, can be structured to meet regulatory requirements when predetermined tenors in debt tranches are established at the outset. This makes CRE debt an appealing investment for annuity funds where additional liquidity on CRE debt may be potentially captured through the Solvency II matching adjustment.\(^1\)
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  - In theory, directly originated CRE debt can be structured to meet the insurer’s requirements. However, in practice, the use of prescriptive mandates to meet regulatory requirements may restrict the volumes of CRE debt which can be originated.

- Potential high spreads and security also make CRE debt attractive for participating business funds and, potentially, shareholder assets. As these investments do not target a matching adjustment, a less prescriptive mandate is possible — and may lead to higher margins and origination volumes.

“We’ve gone into CRE debt to make money. Many want finance and relatively few are in a position to provide it. This imbalance in favor of lenders presents a profitable opportunity. You can also earn fees – which are at expanded levels compared to where they have been traditionally.”\(^2\)

– Ashley Goldblatt, head of commercial, L&G Investment Management

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1. The matching adjustment is a mechanism that enables insurers to increase the rate used to discount their non-commutable liabilities (e.g., annuities) to reflect the premium provided on assets to compensate the investor for illiquidity. However, there are strict rules regarding which assets are eligible for the matching adjustment — e.g., the cash flows must be fixed.

2. Searching for Investment: insurers as lenders, DLA Piper, 2012, p. 6
From a regulatory perspective, Basel III aims to increase both the quality and quantity of capital held by banks. In contrast, Solvency II aims to protect policyholders through assurance that capital positions are aligned to the risks to which insurers are exposed. The potentially favorable capital treatment of CRE debt under a Solvency II framework adds to the demand for quality, investment-grade CRE debt when compared to banks.

Given the illiquid nature of some long duration insurance liabilities (i.e., annuities), insurers are able to invest in less liquid assets if these are held to maturity with the intention to match such liabilities. When compared to their liquid equivalents, certain illiquid assets have more complex structures and lower loss-given-defaults. This can result in the illiquid assets providing equivalent returns to liquid assets while having lower long-term expected credit risk losses. This provides a higher illiquidity premium when held to maturity (see figure 3), which increases IFRS and statutory profits.

Increased competition and the likely need to develop attractive alternative savings products for retirees, triggered by industry events such as the UK 2014 Budget announcement and the Retail Distribution Review, has increased the need for insurers to achieve high asset returns.

Figure 3. Comparison of illiquid and equivalent liquid assets

In addition to credit and illiquidity, asset spreads will also include components associated with other asset characteristics, e.g., optionality and management costs.
How insurers invest

UK insurers have actively invested in CRE debt during the last two years. Publicly discussed examples include:

- M&G invested £266 million with Round Hill Capital in a senior loan to acquire a student housing portfolio.
- In March 2013, MetLife announced it had become the largest portfolio lender in the insurance industry in 2012, with US$43.1 billion in commercial mortgages, including a number of investments in UK properties. This included a US$264 million loan on the Broadgate West office complex in London.
- Legal & General recently invested £121 million in student accommodation to back their annuity portfolio from the developer, UNITE.
- In July 2013, Friends Life announced a £500 million investment mandate with Prudential Financial to invest in CRE loans for Friends Life's annuity funds. The assets are planned to be senior secured, fixed-rate loans with maturities of between 5 and 15 years.
- In September 2013, Standard Life Assurance committed £250 million for investment in CRE debt with Standard Life Investments via a segregated mandate.
- In October 2013, Guardian committed £350 million for investment in UK office, retail and industrial CRE debt with Renshaw Bay via a segregated mandate.
- In July 2014, Pension Insurance Corporation invested £114 million in a loan to finance the redevelopment of student accommodations for the University of London.

The issue which insurers face is how to get access to long-term quality CRE debt in a market where such assets are not actively traded. Our observation of typical CRE debt structuring has primarily involved access through:

- Sourcing via third parties in the market (e.g., through segregated mandates to investment managers or banks); this is where recent activity has been taking place, for example, relationships between Standard Life and Standard Life Investments, and Friends Life and Prudential Financial.
- Direct origination in the market, which adds tremendous operational complexity, but potentially retains further upside and value for the organization.

The following diagram shows a typical CRE debt structure.

**Figure 4. Investing in CRE debt, direct and secondary market**
Commercial real estate debt as an asset class

Sector overview and CRE debt structuring

CRE debt can predominantly be categorized into four sectors (office, retail, industrial and residential) – each with different risk characteristics (see figure 5 for a breakdown of new CRE debt origination completed by sector in 2013).

Within these sectors, three main types of facilities are typically found:

- **Investment facilities:** CRE debt funding consists of funding for the acquisition of property. The ability of borrowers to service the debt is dependent on a strong stable income from a quality tenant base – in general, organizations with a global presence, strong brand or known market presence and track record.

- **Quasi real estate:** CRE debt funding consists of funding for a specific type of real estate, for example, debt servicing is dependent on the revenue of an operational asset, such as hotel income.

Because insurers target assets that provide a stable and known cash flow pattern, they have predominantly invested in investment facilities. The cash flow pattern at loan issuance of development and quasi real estate may involve drawdown facilities which can have expected dates that may be contingent on events/milestones within the project. This results in a risk and cash flow profile that is inherently different from investment facilities.

- **Commercial and residential development/construction:** Funding is required for the development or redevelopment of property, and key to the debt servicing is the ability of the borrower to build out and source purchasers or quality tenants. In this situation, the borrower would require debt for both a “construction phase” (whereby funding will be drawn from a committed fund made available) and an “operational phase” (where the project has no construction risk). In most situations, the borrower would typically sell the property – with no operational phase in the debt financing. However, in some circumstances, the construction phase automatically rolls over into an operational phase instrument, which has similar characteristics to the investment facility described above.

Large rolling credit facilities (RCFs) typically form part of the structuring of CRE debt and are generally unsecured. Insurers have not usually invested in these facilities, due to the fluctuation and unknown cash flow patterns. However, the potential exists for banks to partner with insurers holding short-term liabilities (e.g., non-life companies) to develop a product to meet this demand.

Figure 5. New CRE loan origination completed, by sector, 2013
Investment considerations

Key considerations for insurers before investing in CRE debt are:

- **Tenant quality:** The credit quality of the tenant and sustainability of its business is a key driver of default risk in CRE debt. This risk is typically captured by applying a credit rating framework to the tenant. This framework assists the borrower to determine the likelihood of the tenant meeting future debt payments by calculating metrics such as a debt service coverage ratio (DSCR) and other financial ratios, in addition to industry considerations.

- **Loan to value (LTV):** This is a key loan covenant which sets a limit on the outstanding loan amount as a percentage of the underlying property and, therefore, impacts the level of borrowers’ exposure to the property market. According to the De Montfort University study, the average LTV from recent originations has been c.65%. In our experience, a LTV lower than 70% is likely to be required in the current market for an investment grade loan.

CRE loans will typically be amortizing and the LTV will reduce throughout the term of the loan. The credit rating for CRE debt also typically reduces as the LTV increases. This can be seen in figure 7 for UK commercial mortgage-backed securities (CMBS) which is a reasonable proxy for CRE debt.

![Figure 6. Average maximum LTV by sector, 1999-2013](source)


<table>
<thead>
<tr>
<th>Rating</th>
<th>Target LTV</th>
</tr>
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<tr>
<td>Aaa</td>
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<tr>
<td>Aa2</td>
<td>53%</td>
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<tr>
<td>A2</td>
<td>61%</td>
</tr>
<tr>
<td>Baa2</td>
<td>69%</td>
</tr>
<tr>
<td>Baa3</td>
<td>72%</td>
</tr>
</tbody>
</table>


- **Tenor:** To match longer-dated liabilities (e.g., annuities), insurers invest in loans with longer durations than those issued by banks. The current relatively low volumes of long term CRE debt, shown in figure 8, are a result of both the relatively limited borrower demand for long-term CRE debt and the secondary market supply of long-term CRE debt. This is partially due to the dominant role banks have played in the CRE debt market.

- **Spread:** Spread in excess of 200 bps above LIBOR has typically been targeted by insurers on long-dated senior secured CRE debt. Following an increase in spreads triggered by the global financial crisis, spreads have begun to narrow in recent years (illustrated in figure 1 on page 3). In some cases, we have observed a larger spread narrowing at longer durations, driven by increased supply of funds at longer terms.
• **Project type:** As mentioned on page 7, insurers are reluctant to invest in development properties. Compared to investment facilities, these typically have a different risk profile and cash flow uncertainty due to undrawn commitments (not possible to match annuity cash flows with certainty). Investment facilities limit the debt market for insurers specifically to investment facilities.

• **Size:** Given the detailed and costly legal due diligence and internal credit assessments performed by insurers before investing in illiquid loans, loan sizes in excess of £50 million are typically targeted. These big ticket loans are not readily available. In an increasingly competitive market with more insurers on the hunt for CRE debt, the desire for large ticket size adds to the reduction in spread on CRE debt as a result of higher market prices paid.

• **Financial structure:** Insurers typically avoid loan optionality, especially of borrowers to prepay loans, due to complexities of matching and hedging, as well as matching adjustment eligibility constraints. The existence of such complexities in loan covenants reduces the availability of suitable existing loans for insurers.
Insurers are required to hold regulatory capital against the risks introduced by their investments. The introduction of Solvency II has increased the need for insurers to understand and model the risks to their business as part of the Solvency Capital Requirement (SCR). Solvency II allows insurers to quantify their SCR capital using the standard formula or an internal model. Under the standard formula, the capital requirement for CRE debt is the same as that of an equivalently-rated unsecured corporate bond. There is, therefore, a motivation for insurers to develop their own risk models as part of an internal model (or partial internal model) in order to benefit from the secured status of CRE debt, and develop a stronger understanding of the risk profile of these investments.

In this section, we outline the key challenges associated with developing CRE debt capital models and walk through an example illustrating potential capital requirements.

Key challenges for CRE debt capital modeling

- **Data**: Relevant historic default data on CRE debt is limited, making it difficult to derive a data-driven capital model. The extensive variability of the CRE market (across sectors and geographies) exaggerates this issue, emphasizing the need for the data and its limitations to be understood. Potential data sources that can be used to calibrate a capital model include:
  - **Survey data**, such as the De Montfort University study **UK Commercial Property Lending Market Research Findings 2013 Year-end**. This study has the key advantage of capturing data from the majority of the UK property lending market. However, for capital modeling, the survey data has the following limitations:
    - The data granularity is not sufficient: default data is not subdivided.
    - The nature of the data (survey responses) exposes it to biases. For instance, survey participants may attempt to keep spreads artificially high by over-quoting spreads achieved.
  - **Non-public data sources**, such as IPD Giliberto-Levy Commercial Mortgages, which is a spread index comprised of CRE loans held on the balance sheet of institutional US lenders. The default component of the spread is also calculated by leveraging CMBS data. The key limitations of this data source include:
    - All participants are required to provide three years of data and pay a fee of about £15,000 per annum.
    - A non-transparent model is used to calculate the default loss allocation, which may lead to issues under Solvency II.
  - **Proxy data**: There are various rich publicly available datasets that can be used as a proxy for CRE debt. Possible proxies include:
    - **CMBS**: These have the key advantage due to the fact that the defaults and transitions are explicitly linked to the performance of CRE loans. However, high levels of transitions during the financial crisis arising from changes to the rating methodology make it difficult to use this data set without adjustment.
    - **Corporate bonds**: Despite being a credible and rich dataset, the lack of explicit property risk captured can lead to low default rates predictions which, in our view fail to reconcile to the small amount of non-granular CRE debt data available.
Modeling approaches: There are various approaches for modeling CRE debt, including the two most popular:

1. Tenant models where the probability of default (PD) and loss given default (LGD) are explicitly estimated using a factor model.
   - A credit scoring framework is applied to the tenant to estimate the PD, which will include considering the debt service cover ratio (DSCR), business plan, credit history, and other factors.
   - The LGD is estimated by considering factors including the current and stressed property valuation and levels of government support.

   The key advantage of this model type is transparency of approach and specificity to loans held. However, as a result of the lack of data noted above, it is challenging to calibrate a model of this type to Solvency II statistical standards.

2. Proxy model, where the CRE portfolio spread is deconstructed into its underlying risk factors which can be modeled separately using proxy data.
   - The key advantage of this approach is that it leverages wider data, which leads to a statistically credible, robust and stable calibration.
   - However, the generalized approach can overlook some specific asset characteristics and should be complemented with scenario and specific asset analysis.

CRE debt capital modeling example

As no liquid market for CRE debt exists, there is limited data available to calibrate a spread risk stress and no clear mechanism for deconstructing the spread into components attributable to credit and liquidity (referred to as the credit and liquidity spread). To overcome this, the proxy model approach (illustrated in figure 9) can be implemented, leveraging available market data to calibrate a spread risk stress for a CRE debt portfolio:

The approach involves the following key steps:

1. Identify indices that reflect the relative levels of credit and liquidity risk present in the market (referred to as market credit and liquidity indices)

2. Estimate the through-the-cycle (TTC) credit and liquidity spread for the CRE debt portfolio, which is used to scale the market indices identified in step 1 to make them specific to the CRE debt market

3. Adjust the specific indices derived in step 2 to reflect the idiosyncratic credit quality of the actual portfolio under consideration by credit scoring the individual loans

4. Calibrate specific liquidity and credit spread distributions

5. Perform scenario testing to assess the suitability of the calibrated spread shocks and the implied level of required capital; each of these steps is considered in more detail in the sections below

Figure 9. Implementation of a proxy model
Step 1: Identify market credit and liquidity indices

The aim is to identify two indices that represent the relative levels of credit and liquidity in the market. The indices identified will then be used as a proxy for the credit and liquidity spread movements in the CRE debt spread. In order to identify the appropriate proxy, various market indices are analyzed by considering:

- Market relevance
- Availability
- Correlation with the CRE debt reference index (described in step 2)

The idea behind this approach is that the theoretical (non-observable) CRE debt spread can be deconstructed into a linear combination of the market credit and liquidity indices:

Theoretical CRE debt spread = α * market credit index + β * market liquidity index

Where α * market credit index and β * market liquidity index are the specific credit and liquidity indices outlined in step 2.

Step 2: Estimate the average credit and liquidity spread for CRE debt

Deriving the specific credit index:

First the TTC credit spread is derived using a triangulation approach, which involves considering:

- The credit spread implied by applying the Jarrow, Lando and Turnbull (JLT) Model to CMBS default and transition rates; the historic CMBS transition rates require an adjustment to allow for rating methodology changes following the global financial crisis
- The PD implied by publicly available data (e.g., the above-mentioned De Montfort University commercial property lending study) and proprietary default data, where available
- The LGD implied by considering shocks to the commercial real estate property price, as well as proprietary and publicly available recovery-rate data
- Benchmarking with the wider CRE debt market. This typically involves considering banking models, which have historically been more sophisticated than those used by insurers

This approach leads to a segmentation of the TTC credit spread according to the LTV of the CRE debt. Indicative calibrated results are for long-term (about 15 years term to maturity), BBB- rated CRE debt, as shown in figure 10. The specific credit index is then derived by scaling the market credit index to align its historic average to the TTC credit spreads derived.

<table>
<thead>
<tr>
<th>LTV</th>
<th>TTC credit spread</th>
<th>Approximate % of spread</th>
</tr>
</thead>
<tbody>
<tr>
<td>LTV &lt; 50%</td>
<td>30 bps</td>
<td>15%</td>
</tr>
<tr>
<td>50% &lt; LTV &lt; 60%</td>
<td>40 bps</td>
<td>20%</td>
</tr>
<tr>
<td>60% &lt; LTV &lt; 70%</td>
<td>60 bps</td>
<td>30%</td>
</tr>
</tbody>
</table>

TTC credit spreads for a BBB CRE debt with 15 years to maturity.

Figure 10. LTV calibrated results

Potential credit indices
- iTraxx Eur CDS indices
- iBoxx Eur Corporate indices

Potential liquidity indices
- iBoxx Covered Bonds indices
- LIBOR OIS
Deriving the specific liquidity index:

The TTC liquidity spread is derived by first identifying publicly-traded bonds which are issued by the same or similar borrowers to the ones in the CRE debt portfolio and using the time series spread data available on these bonds to construct a reference index. This index will be broadly representative of the CRE debt market after an adjustment is made for the additional illiquidity and borrower optionality on loans relative to bonds. Depending on the volume of available market data, it may be possible to construct a separate reference index for different credit ratings, sectors and terms. An index for general long-term, BBB-rated CRE debt is shown in figure 12.

Figure 12. Historic time series — UK CRE bonds, 2006-14

The TTC liquidity spread is then derived using the following process:

- Subtract the specific credit index from the reference index to derive an index representative of the historic liquidity spread.
- Calculate the TTC liquidity spread as the historic average of this derived index.

The specific liquidity index is derived by scaling the market liquidity index to align its average to the TTC liquidity spread.

Figure 13. Scorecard for asset level specific spread adjustment

**Step 3: Adjust specific indices to reflect idiosyncratic credit risk within the CRE debt**

The derived specific indices are scaled to reflect the idiosyncratic credit risk within the CRE debt portfolio by considering the credit quality of the actual CRE debt assets relative to the reference index. In order to achieve this, a granular credit score is derived by applying a scorecard rating approach to assess the credit quality of the borrower – using a regression to adjust the indices to make them specific at an asset level.

The spreads are also adjusted to reflect the tenor of the actual CRE debt assets relative to the reference index.

**Scorecard**

- Issuer specific drivers
- Generic drivers
  - Tenant quality
  - Property type
  - LTV
  - Political
  - Regulatory

\[ F_n \]

\[ \text{Individual asset score} \]

\[ \text{Asset level specific spread adjustment} \]
Step 4: Calibrate specific credit and liquidity spread distributions

In order to calibrate credit and liquidity spread shocks, the specific indices are transformed before movement data is sampled to fit a distribution.

Figure 14. Calibrating credit and liquidity spread shocks

Spread time series
\( \{s_0, s_1, s_2, s_3, \ldots \} \)

Transformed Spread
\( \{\tilde{s}_0, \tilde{s}_1, \tilde{s}_2, \tilde{s}_3, \ldots \} \)

Sampled spread movements
\( \{\Delta_0, \Delta_1, \Delta_2, \ldots \} \)

Various distributions and fitting methodologies can be used to derive the spread shocks. It is important to note that the choice of these can be just as material as the choice of data.

Step 5: Scenario testing

As with all calibrations, and especially those based on proxy data, it is important to consider the overall suitability of the capital requirements produced. This can be achieved by:

- Benchmarking capital requirements against those for asset classes where sufficient credible and relevant data is available, e.g., corporate bonds
- Considering qualitative stressed CRE debt scenarios and ensuring that the calibrated capital requirement is sufficient to withstand these; for example, considering the disposal value of the underlying property
- Using the limited available PD and LGD data to ensure that the capital held against a spread widening event is sufficient to withstand the worst-observed annual combined PD and LGD event
- Benchmarking the capital requirements against those used by other insurers and in the banking industry (e.g., comparisons to the Basel Stress Test)
- Testing for concentration risk in the portfolio; defaults are unfortunately binary events, and so a portfolio of one commercial real estate asset may have to be assumed to default in a 99th percentile event − this may increase the capital determined from a proxy model that assumes a diversified portfolio

Figure 15. Credit and liquidity spread widening

Credit and liquidity spread widening for typical BBB rated CRE debt with 15 years to maturity

Various distributions and fitting methodologies can be used to derive the spread shocks. It is important to note that the choice of these can be just as material as the choice of data.

Working through these steps will give rise to calibrated credit and liquidity spread widening stresses for each asset. These can then be aggregated to portfolio-level stresses. In regulatory regimes where credit risk adjusted spread can be reflected in the liability discount rate, capital requirements may be reduced by only holding capital against the widening of the credit component of spread. Figure 15 illustrates the credit and liquidity spread widening stresses for a typical CRE debt portfolio.

Figure 15. Credit and liquidity spread widening

Credit and liquidity spread widening for typical BBB rated CRE debt with 15 years to maturity

<table>
<thead>
<tr>
<th>LTV</th>
<th>60% &lt; LTV &lt; 70%</th>
<th>50% &lt; LTV &lt; 60%</th>
<th>LTV &lt; 50%</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Liquidity spread widening</td>
<td>Credit spread widening</td>
<td></td>
</tr>
</tbody>
</table>

0 50 100 150 200

LTV < 50%

50% < LTV < 60%

60% < LTV < 70%

0 50 100 150 200

Liquidity spread widening Credit spread widening
Concluding remarks

Current market conditions with low interest rates have made organic growth in the financial services industry difficult and have helped drive insurers toward new and alternative opportunities in the pursuit of higher risk-adjusted yields. Many insurers are therefore considering alternative investment strategies to remain competitive in a difficult economic environment. One such method is to sell liquid assets and invest in illiquid assets, such as CRE debt.

CRE debt has the potential to provide an investment solution for a variety of insurance funds. In particular, the potential for a higher illiquidity premium makes CRE debt a potentially capitally efficient investment for annuity funds.

Over the past two years, we have observed a number of insurance companies investing in CRE debt; examples include Guardian, Friends Life, MetLife and Standard Life. We expect this new and exciting asset class to grow through more insurance investment in the near future as mandates expand, offering the potential for attractive risk-adjusted returns to insurers in a competitive market.
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EYG no. EG0223
CSG/GSC2013/1467916
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