Finance

What to expect from the life insurance companies in 2016

Cooper Williams
Principal, Essex Financial Group, Denver

In early 2014, I wrote an article for the Colorado Real Estate Journal about the paradigm shift that was occurring in commercial real estate lending. The status quo was changing – banks were breaking the norm and doing longer-term, nonrecourse loans on their balance sheets, while more life insurance companies were taking construction risk and providing more variable-rate debt to match short-term annuity businesses. My thesis was that there was no such thing as "normal" in today's lending environment, capital sources and loan products were being blurred, and, as a result, borrowers were benefiting from more capital options and better pricing power.

Fast-forward to today. Banks are now being more selective with their longer-term fixed-rate programs in anticipation of the Federal Reserve beginning to normalize monetary policy in December; however, the life insurance companies continue to blur the lines with new lending programs as more and more of them continue to search for yield in this low interest rate environment. The best example is the ongoing creation of short-term, nonrecourse "bridge" programs for transitional assets. In an effort to find more yield, several life insurance companies are taking additional, calculated risk on transitional assets with either above-market vacancy or near-term tenant rollover. These "bridge" programs can be tailored for specific assets, fund up to 75 percent of total project cost, and provide future fundings for improvements and leasing capital to help execute specific business plans. In essence, these new life insurance company programs mirror traditional bank lending, but come with fixed-rate options and without personal guarantees.

While there continues to be a focus on increasing yields and overall returns going into 2016, the life insurance companies also will be heavily focused on increasing their core, long-term lending businesses to match up with their increasing long-term liabilities. The common theme coming from most life insurance company investment committees is a desire to increase their mortgage allocations next year, given the good yields, cash flow predictability and relative value of the assets compared to alternative investments. In my opinion, there has never been a better time to secure long-term financing with increased lender appetite, new and ever-changing lending programs and rising concern of rising rates. Below are four ways in which the life insurance companies will increase their commercial mortgage allocations in 2016:

■ **Forward loan commitments.** A majority of life insurance companies are still willing and able to provide forward loan commitments for up to 12 months in advance of funding. The forward commitment allows borrowers to lock interest rates now, while they remain low, and have a firm loan commitment subject to any substantial changes to the property and its economics. While forward loan commitments can sometimes come with a small interest rate premium (two to four basis points per month beyond a three-month free period), the certainty of execution and minimal increase to the overall coupon can be extremely valuable in an uncertain interest rate environment.

■ **Longer-term loan options.** Essex Financial Group works with several life insurance companies through a correspondent network that are now offering longer-term loan options beyond the traditional 10-year fixed-rate period. In fact, the average loan term originated by Essex Financial Group between 2014 and 2015 was 12 years. Several life insurance companies now have 20- to 30-year fully amortizing loan programs that match up to longer-term liabilities on their balance sheets (one specific lender even has a 40-year fully amortizing option). The most significant benefit to these longer-term loan options is locking in a very low interest rate for a significant period of time, eliminating future interest rate risk and fixing the most important variable to predictable cash flow. Essex currently is in the market on several 30-year fully amortizing loan requests, and the pricing for such product ranges between 4 and 4.75 percent, depending on the property type and leverage request. Although most of these longer-term options come with prepayment penalties, some life insurance companies will provide future earn-outs to increase loan proceeds with future value creation.

■ **Construction loans.** The trend of life insurance companies competing in the construction lending space with new and revitalized construction loan programs continues to increase. The concept is to secure the permanent financing by taking the construction risk and providing the construction financing. The ideal structure for most life insurance companies include a 12- to 24-month construction period with necessary completion guarantees, followed by a minimum five-year loan term and maximum 30-year loan term upon construction completion. The benefit to the borrower is a fixed interest rate during the construction and permanent periods, plus a guaranteed takeout at construction completion. Although originally conceived to lend on ground-up apartment projects to steal market share from Fannie and Freddie, programs have evolved to fund credit tenant commercial projects and select retail, office, industrial and hospitality developments. Most life insurance company construction loans need to be larger than $20 million on assets located in primary markets.

■ **Construction loan takeouts prior to stabilization.** For years, Fannie Mae and Freddie Mac dominated multifamily lending and financed the lion's share of stabilized apartment communities, consistently beating life insurance companies with higher loan proceeds, lower interest rates and longer amortizations. Although much more competitive today with lower spreads and whole interest rates than agency executions, life insurance companies continue to find ways to steal market share from Fannie and Freddie. A proven and successful tactic has been to take out apartment construction loans at construction completion, prior to lease-up and stabilization. Typically, life companies won't fund until the property is generating a 1.00x debt coverage ratio. In addition, this type of financing execution may require additional credit enhancement (i.e. master lease, debt service reserve, personal guaranty) until there is sufficient cash flow to cover debt service 1.25x, but the credit enhancement burns off and the loan becomes nonrecourse once the property's cash flow covers the debt obligation. ▲