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For U.S. Life Insurers, The Pain From Real Estate Could Lie Ahead

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America's deteriorating commercial real estate picture has a special resonance for U.S. life insurers because of the approximately \$310 billion, industry wide, that they've invested in commercial and multifamily mortgages. Life insurers gravitate to these assets because they are fixed-income in nature and long-term in maturation, making them especially well-matched with insurers' liabilities: the annuities and life insurance policies they sell. (Insurers often underwrite mortgages with different durations—for instance, of five, seven, or 10 years—to hedge their risks and ensure consistent income.) But when the real estate markets begin to sour, the possibility exists that commercial mortgages will default and perhaps take a toll on ratings.

So far, Standard & Poor's Ratings Services believes that this has not happened. Currently, the foreclosure rate of commercial mortgages in life insurance portfolios is virtually zero. But we believe that this will not necessarily be the case over the course of this economic cycle. Commercial real estate performance is generally a lagging economic indicator. Owners tend to cut all other expenses before defaulting on their mortgages or letting property go into foreclosure. Therefore, as the recession rolls on, we believe that there is an increasing possibility of distress for commercial real estate owners and for those that hold their mortgages.

In February, we conducted stress tests that simulated two depressed real estate markets between 1988 and 1995 (see "Methodology For Incorporating Incremental Stress Factors," published on Feb. 18, 2009, on RatingsDirect). In these tests, we paid special attention to the capital that might be needed to support the three largest components, overall, of life insurers' own portfolios:

- Corporate bonds, which make up a roughly 70% share.
- Whole commercial real estate loans (10%).
- Commercial mortgage backed securities (CMBS), which are about 5%.

Various other investments make up the remaining 15%.

With this testing, we found that the recession, upon its completion, will definitely take its toll on required capital levels appropriate for certain rating levels. The impact of the capital stress test was central in affecting ratings. Within the capital stress test, however, corporate bonds played the major role in affecting projected defaults on an insurer's capital, while commercial mortgages and CMBS projected losses had less of an impact.

Our stress tests indicate that we'd typically have to see net losses from foreclosures of 5% or more before we'd see any rating impact, though insurers with a greater-than-average exposure to commercial mortgages would be more vulnerable. Although the overall impact of commercial real estate remains muted, that could change because many mortgages were made before the recession began, when occupancy rates and property prices were stronger. The projections that made deals attractive in 2005, 2006, and 2007, however, could prove to be too optimistic.

Despite these potential dangers, we believe that the life insurance industry remains generally well-capitalized. Although we lowered the ratings on 18 issuers following our February tests, only two companies—Conseco Life Insurance Co. (BB-/Negative/--) and Security Benefit Life Insurance Co. (BB/Negative/B)—carry a speculative-grade financial strength rating. Given the dour economy, however, 14 of these 18 companies have negative outlooks or ratings on CreditWatch with negative implications. Trouble in their commercial mortgage holdings, just by itself,

might not lead to downgrades. But that trouble could easily be a contributing factor if life insurers' other portfolio holdings, along with the economy, continue to head south.

The Advantages Of Not Being A Bank

Our crystal ball won't tell us precisely the length and depth of the recession. Nor can we predict the state of the real estate markets for every type of mortgage an insurer holds in every geographic market. But life insurers do hold some advantages over banks that can help them skirt a major commercial real estate meltdown:

- Life insurers generally don't make short-term real estate loans. Unlike banks, they don't usually like construction or development loans, which don't have regular cash flow. Life insurers typically prefer to offer the permanent financing that replaces these earlier loans.
- Unlike commercial banks, insurers' hold their whole loans at book value rather than being marked to market. This means that except in the worst of circumstances—namely, a high liquidity need—their assets will not be impaired, resulting in lower capital needs. It also means that in the cases where they actually own real estate, in a good market, they can sell it for far more than book value.
- Life insurers are less affected by developments in the structured finance markets. Because of their long experience in underwriting mortgages, when they do purchase CMBS, they generally invest in the most senior and highest-rated tranches. There has been very little impairment so far in their CMBS holdings, and 95% of them, industry-wide, are rated 'A' and higher. Within the 'AAA' tranches, life insurers tend to take position in the highest and most protected layer of the capital structure.
- Life insurers have also shied away from the riskier forms of asset-backed securities (ABS) and residential mortgage products. For example, we see limited life insurance holdings of collateralized debt obligations (CDO) that are backed by residential mortgage-backed securities (RMBS). Although RMBS impairment has been noticeable, the holdings of life insurers tend to be very high quality compared with those of banks.

Knowing Their Markets

The projects insurers back vary widely, from local strip malls to major hotel and office projects in big cities. But one of the things that life insurers have generally done that has served them quite well is to limit their commercial mortgage activity to markets they know well, both in terms of size and geography.

A large insurer like Metropolitan Life Insurance Co. (AA-/Negative/A-1+), for instance, can underwrite large projects such as New York City office buildings or major hotels because it has long had the size, strength, and expertise to undertake such major projects. At the same time, smaller companies, like Mutual Trust Life Insurance Co., which is based in suburban Chicago, has developed ongoing relationships with customers in its Midwest home turf and is a lender to many projects in that region.

Of course, anyone underwriting a commercial project has to be aware of the market dynamics by property type as well. But overall, it is tough for everything right now. Standard & Poor's believes that the recession appears to be adversely affecting all commercial real estate property sectors. Job losses, reduced consumer spending, and the rapid decline in wealth have reduced demand for commercial real estate space. We believe that these events, in combination, have already driven vacancy rates higher for all major property classes in the first quarter of 2009 (see "CMBS Quarterly Insights: Delinquency Rate Is On The Verge Of Passing Previous Peak," May 7, 2009,

RatingsDirect).

Increased joblessness has pumped up vacancy rates in multifamily housing. We expect retail mortgage delinquencies to continue rising because of weak conditions in that sector. Declines in both business and leisure travel are hurting hotels and motels. And although office demand is the strongest of the major property types, we still expect office delinquencies to increase in 2009 as sublease space generates excess inventory while concessions and lease renegotiations pressure operating cash flow.

Life insurance companies have inherent advantages over banks that (so far) have kept them from the worst fallout in this financial crisis and kept their real estate investments relatively healthy. But the course of this recession remains uncertain, and if it becomes more severe than anticipated, commercial real estate holdings could weigh more heavily on these insurers than they'd like.

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