Karissa Anderson & Sarah Swartzendruber

Episode 211: CMLs: The benefits of time-tested expertise and in-house servicing

GUEST Q & A

Stewart: My name's Stewart Foley. I'll be your host. We've got a great podcast for you today, and the topic is commercial mortgage loans, otherwise known as CMLs in our world. And we're joined by Karissa Anderson, head of CML production, and Sarah Swartzendruber, managing director of US Real Estate Asset Management at Aegon Asset Management. Karissa, Sarah, thanks for joining me. Thanks for being on.

Karissa: Thanks for having us.

Sarah: Thanks for having us.

Stewart: Okay, so we'll start this one the way we always do, a little bit of an icebreaker. Karissa, where did you grow up? What was your first job? Not the fancy one. And what do you think makes insurance asset management so cool?

Karissa: So I grew up in a small town in northern Iowa, and my first job was waiting tables at the local diner. I've heard people say over the years that it is impossible to multitask. And when people say that, I know they've never worked in the food service industry.

Stewart: That's so true.

Karissa: Yeah, exactly.

Stewart: So is it one of those diners where there's a table full of old men that gather every morning about-

Karissa: 9:00.

Stewart: 9:00. Because where I grew up, that table started about 5:30. And by about 7:30, you were late and people were starting to leave.

Karissa: Yeah, this was the local 9:00 business group and they rolled dice every day to see who was paying for coffee.

Stewart: Oh, I like it. I like it. And what makes insurance asset management so cool?

Karissa: I think not just insurance asset management, but real assets in particular. For me, it's the people. This is really a people and a relationship business. And the relationships and friendships I've built across this industry over the last three decades are just irreplaceable. It's truly a people relationship business.

Stewart: I love that. Sarah, how about you? Where did you grow up? Let's stick with the first job. I think it's good. And then what do you like about insurance asset management in particular? I mean, Aegon is a massive insurance company. The asset management area of it works with other companies other than just Aegon. But you're steeped in the tea here, so I'm hoping you've got some good color for us.

Sarah: Sure. Well, to start off, I grew up in Iowa City, Iowa, which is the home of the University of Iowa and the Iowa Hawkeyes. So if anybody's been following college basketball, it's the current home and fan base of Caitlin Clark, which has made up for a couple of really exciting years for us.

Stewart: Oh, that's super cool. Yeah, well done. So you're both from Iowa. That's awesome.

Sarah: Yeah. My first job was working in the University of Iowa College of Business. It was back in the day when professors used to hand out hard copies of documents to students, exams, assignments, and reading materials, and my job was to make copies for those professors. And so I would stand at the copy machine and read what they had provided. I didn't understand a whole lot of it because I was pretty young back then, but it was a really interesting exposure to business concepts and terminology.

Stewart: That's super cool. And what do you love about this business?

Sarah: I like solving problems. I like hard things and puzzles. And there's no shortage of hard work and challenges and complexities in asset management, so I find that work really motivating and really rewarding.

Stewart: Yeah. A friend of mine described it as externalities. Managing money for insurance companies involves a whole lot of externalities, and there's a whole lot of things to consider just beyond the capital markets. And I know you both are intimately familiar with that.

So just to kick it off, Karissa, when I think about CMLs, I think about long duration assets that are securitized and offer an alternative to public credit. Can you talk a little bit about why insurance companies find this asset class are so active in it and the benefits of commercial mortgage loans, just at a high level?

Karissa: Sure. CMLs offer relative value and diversification over publicly traded fixed income securities. They also provide potential benefits such as liability duration matching, capital efficiency, cashflow stability, and some CMLs are really customizable. If there's a specific need for certain duration or a risk profile, the lender can usually find that out in the market with relative ease. And these make these assets perfect for life company portfolios.

Stewart: Is there a typical duration associated with a CML? I mean, is there a standard loan structure or is it more bespoke?

Karissa: It's truly bespoke. If a lender has extremely long duration needs, we can find that for them. Right now, it's really hard to find that because of what's going on in the market with interest rates, everybody wants to short. However, if a lender needs a 3-to-5-year duration, that's available as well.

Stewart: That's cool. And so just so everyone's aware, Aegon Asset Management is part of Aegon, which is a massive insurance company. And Transamerica here in the US is part of that as well. Can you remind me and our listeners of the relationship between Aegon Asset Management and Transamerica on the commercial mortgage loan side? And just kind of set the stage for the rest of the podcast in terms of how you work together.

Karissa: Sure. We began investing for them about 40 years ago, and we currently have a portfolio of about $11 billion on our general account. We also manage assets for third party investors, and we have about $3 billion that we're managing for them.1 Typical loan sizes are around $15 million with a range of $3 to $50 million depending on the size of the insurer. We invest across all major sectors, primary, secondary, and tertiary markets. We're headquartered in Cedar Rapids, Iowa, so we understand the nuances that are outside the top 100s. We've historically and continued to be an active investor in those markets when opportunities present themselves.

Stewart: Yeah, it's funny, I had a friend who covered your shop in Cedar Rapids from Chicago, years and years ago. I have fond memories of that area. So Karissa, a lot has changed in the market environment in the last two years in this space. You just referred to it a moment ago. And for all asset classes, but in particular, how has CML origination and allocation been affected?

Karissa: Yeah, there's still a really wide disconnect between buyers and sellers. Fourth quarter transaction volume was usually typically the strongest of the year. Last year was $89.5 billion, down about 41% compared to a year earlier.2 We do expect that transaction volume to pick up gradually through 2024 for a number of reasons. Everybody's hoping for a declining 10-year Treasury. Some property owners are going to be forced sellers in '24. They're facing potential refinance risks. Others are going to require significant capital infusion or their lenders just going to deny additional extensions. And then I think there's going to be an influx of opportunistic capital, which will increase transaction activity likely both through direct property acquisitions and distressed loan sales. Hopefully, this will provide some much needed liquidity in the market.

In terms of rates, the declining 10-year Treasury hopefully will help. CML spreads are adjusting to this, but at a little bit slower pace. We're now in the 115 to 215 basis point range for good quality 5 and 10-year loans. However, corporate bond spreads continue to tighten as well, which is maintaining that CML to corporate spread gap. Through this period of volatility, life companies have remained disciplined in their lending standards with most having similar allocations in '24 compared to '23.3

On the borrower side, rates have come in slightly, but they continue to seek short-term loans. They want interest-only periods and they want flexible prepaid during that last 12 to 24 months of the loan.3 However, with that potential decline in the 10-year Treasury, we do expect that some borrowers will consider longer-term financing options.

Stewart: Yeah, that makes a lot of sense. When you think about this market, what do you think are the most important elements to focus on when you're underwriting deals in general and specifically in today's environment? I guess kind of tacking onto that question, are there certain red flags that you look out for when matching a borrower with an investor? And it really gets into deal flow, right? How would you help educate our audience on that particular area?

Karissa: So in real estate, we usually say it's all about location, location, location. But in reality, a lot goes into underwriting commercial mortgage debt these days. We work with each client, including our affiliate, to develop their loan criteria based on their specific needs.

For example, we had a third-party life insurance client that had a need for some smaller loans so we pivoted our lending criteria and lowered our loan size for them. We had another client with a strong need for long duration, so we actually created a 40-year term multifamily product for them. And in a third instance, we had a client overexposed in retail and office. In this case, we solely originated multifamily and industrial loans for that client.

Specifically, we focus on competitive market fundamentals such as geographic location, cashflow, durability, the sponsor and their financial capacity, demographics as well as stressed asset values. But I think one of the most important elements we underwrite on is the borrower itself. Typically, about 50% of our business comes from repeat borrowers.3 The majority of those have longstanding track records in their property types and submarkets. Most of our borrowers have operated in many years across many interest rate and economic cycles.

In terms of red flags, each investor or client might have different sensitivities towards certain property types or geographic markets or durations that we need to steer clear of. We have some clients that may have an overexposure to a certain state or a property type, so we'll just adjust their lending program to exclude those assets.

In terms of wider red flags, we might shy away from little opportunities that have underwritten rent growth expectations from two years ago, or expense levels that do not reflect the reality on the ground. For example, we aren't going to underwrite a 3% increase for insurance expenses when we have seen annual increases in some markets significantly higher than that. You really have to underwrite based on the reality of that property in that location.

Stewart: That makes a lot of sense. I would think with your internal general account and your external assets, I mean, that's kind of one of the reasons that you go to a shop like yours because you need to see deal flow. And you're going to see that deal flow as a result of being in the market consistently, right? And so as you mentioned, you've done this for a long time and I've got to think that that helps makes it a very compelling story.

Sarah, I want to get you back in here, or in here at all. As you oversee the affiliated and non-affiliated insurance portfolios, is there anything in particular that keeps you up at night?

Sarah: Everybody's talking about it, but office really is a key focus. I think it's probably the primary cause of sleepless nights for asset managers who manage commercial mortgage loan assets. The uncertainty around the future of office is what makes it especially challenging. Some of those loans are facing immediate problems. Those loans at or near maturity, those loans might be experiencing occupancy issues or cashflow shortages or just generally that uncertainty around the future of office that I mentioned.

Each loan and each property is unique, so it's important for asset managers to really dig in and understand and analyze the performance of each property, the position of that property in its market. How does it compare to similar properties? Does it have competitive advantages? You're seeing such nuanced market conditions that even within a particular market or sub-market, there's very different performance and demand for those properties. So really underwriting the property. And then as Karissa had mentioned, really understanding the position of the borrower and if the borrower is going to continue to commit to that asset. If we work with a borrower that's requesting some type of relief, an extension or a modification, we want to see additional commitment and investment from the borrower. That's challenging when borrowers are facing cashflow shortages and future uncertainty.

So I talked earlier about complexities and solving hard problems. These complexities are why it's important to have a special servicing team with deep experience that can analyze those factors for each investor.

Stewart: I think you bring up a great point, which is, when people hear real estate, they immediately go to office. But there's lots of areas that are doing quite well. I mean, I think about data centers as an example of an area that's strong. But just kind of going back to office for a second, given the challenges in the office market, can you talk about your approach to loan workouts? I think that with our audience, when you're an asset owner, this is a particular area that really matters. What happens if something doesn't go as planned the way that you and Karissa are both talking about potential challenges that borrowers are facing?

Sarah: Yeah, that's right. As Karissa mentioned, the duration of these investments varies. And so having teams that can monitor and manage assets over really long life cycles is important. There's no one-size-fits-all solution or approach to workouts. As a starting point, the special servicer's primary objective is to protect that value of the mortgage loan and the underlying collateral. So when the property experiences stress, it's the special servicer's job to develop solutions.

Our team is well positioned to do this. Our mortgage loan servicing and special servicing team consists of about 29 professionals with 15 years of average experience.1 Both our servicing and our special servicing teams are rated strong by S&P, which is the highest rating they issue for those assessments.4 So that helps with my sleepless nights. Our servicing team is the first line of defense in monitoring and surveilling those assets, but when those loans require escalated attention, we do have a dedicated special servicing team that are experts in workouts.

I mentioned earlier our approach to really dig in and understand the collateral and the borrower, but we also work really closely with our investors to understand their needs and preferences. They might have needs that impact a workout strategy, tax implications, capital charges, other business drivers. So being able to pull in property level, borrower level considerations along with investors' needs is a way that deep experience and strong underwriting capabilities and creative solutions all come together to inform that workout strategy.
Stewart: I think it's fair to say that this is an asset class that involves rolling up your sleeves.

Sarah: Yeah, absolutely.

Stewart: You've got to know your client's situation. You've got to know the borrower's situation. You've got to know the property situation. I mean, it just seems like there's no quantitative screen that we can go out and run through, which is, it doesn't work that way.

So Karissa, I want to come back to you. This is a topic that has been on our podcast several times, which has to do with the pullback from banks and lending. And the question, I guess, where I'm headed here is, are you seeing any benefit or opportunities emerge for insurers and non-bank lenders due to the reduced activity of bank lending? And I guess that in particular is regional bank lending because there's a fairly high concentration of commercial mortgage risk on those balance sheets.

Karissa: Yeah, we believe life companies and other non-bank lenders looking to put capital out right now should be well positioned. Borrowers are seeking alternative sources from that reduced bank lending activity. While the pool lenders is much smaller, there is still liquidity there. Our sources are telling us it's pretty hit or miss. You used to be able to get five solid bank quotes, now it's one or two. Some banks are just functionally out of the market. They're only offering really high rates. They're requiring high deposits as a percentage of loan proceeds, or they're focusing only on their top customers. In short, in the current bank environment, full recourse still matters, low LTV matters and relationships matter.

Stewart: And Sarah, one of the areas of concern that we often hear from insurers when it comes to servicing is onboarding. So I think a lot of times it's helpful for insurers hear tips or things that they should be considering from somebody who's in this market day in and day out. What can you comment? Can you help me with that component?

Sarah: Yeah. As I think about onboarding, I think of two different varieties. The first is a client who's starting a commercial mortgage loan investment strategy from scratch. And that type of onboarding is focused on making sure that we create a lending strategy that meets the client's needs. Karissa talked about the customization and the flexibility of crafting that investment strategy. That's the primary focus.

But also from my team's standpoint, we're interested in understanding what's important to a client from a servicing and accounting and reporting standpoint. Different clients want different types and different amounts of information about portfolio composition and stressed assets and maybe have time-sensitive data needs about exposure to catastrophic events or natural disasters. We have standardized reporting that meets a vast majority of those clients' needs, but we also have customizable solutions that can help fill the rest of those gaps. Based on our insurance company roots and our international affiliates, our team also has expertise in gap, statutory and IFRS accounting and reporting. And so being able to offer something other than just cash-based accounting is something that we work with clients to understand their needs as well.

The second version of that includes clients who already have a commercial mortgage loan platform that they want to onboard into our platform. We've done that for other clients in the past, so we've been able to build out kind of a nice project plan. What we have found is that it's really important to get in front of those tasks that have long lead times, setting up bank accounts, establishing IT interfaces. So part of our process is working with clients on the front end to think about those long lead time activities and make sure we get in front of those and we have strong communication about keeping the plan moving forward.

Stewart: That's terrific. And we're kind of coming to the end of this thing, so I'd like to go back to each of you. First, Karissa, what are the final takeaways that insurers should be thinking about when looking at CML investments for the rest of the year and maybe beyond?

Karissa: Sure. I think the most important thing insurance companies need to think about is the risk appetite in their capital treatment regime. If they can afford to add some CM-3 loans, there should be some returns out there commensurate with that level of risk right now. Conversely, if their risk appetite is low, they need to be willing to compete on pricing. The current lending of market right now appears to be more insurers in the latter than the former. But in 2024, and going forward, I think it's increasingly important to work with a manager, like you said earlier, active in the market and who can work with investors to customize a portfolio structure and strategy that really works with their risk needs.

Stewart: I have one question. I don't know what CM-3 loans are. So what does that terminology mean?

Karissa: Sure. Loans are rated based on their risk levels, and CM-3 risk levels are much higher than maybe a CM-1 or CM-2 that get lower capital treatment.

Stewart: Got it.

Karissa: So if a lender wants to keep their capital low, they're going to do less risky loans, but they're going to get a lower return for those loans.

Stewart: And I think the point you made is, if you have the capital capacity, CM-3 loans look attractive on a relative basis.

Karissa: Yes, they do. There are not many lenders out there doing CM-3 loans, so you can get a little bit higher return on those loans right now than you have been in the past.

Stewart: Very cool. Thank you. And Sarah, what about you? What's the takeaway from today's podcast?

Sarah: Yeah, just to add on to Karissa's comments about investors investing across that risk profile, I think it's really important that you've got a strong mortgage loan servicing and special servicing team who can manage those assets over the life of the investment. We place a really high value on keeping that work in-house at Aegon. We believe it benefits our investors for our servicing team to be close to the borrower and property level information. We also believe it's beneficial to borrowers because we can control the service they receive and the lender interactions they experience that generally results in repeat borrower relationships, as Karissa mentioned earlier, which means more exposure for investors to future transactions.
So I would say having that centralized and experienced servicing team is really important for investors to consider, especially right now in times of market volatility like we're experiencing today.

Stewart: It's interesting that you say that because it kind of goes back to what Karissa was talking about, about being actively in the market on a consistent basis that leads to repeat relationships where you build up some trust, right? And that requires being an active participant in the market day in and day out. So that's a great point, and thanks for that.

I've got two fun ones on the way out the door, and I want to give Karissa the choice to take one of the other, whichever one she wants. The first question is, what's a good piece of advice that you've gotten along the way that you'd like to pass along? Or who would you most like to have lunch with, alive or dead? And Sarah, you have to take the other one. I'm sorry.

Karissa: Okay, I'll take the first one. When I was early in my career, I was debating on whether I should start my master's degree or not. And my boss at the time said to me, "You know, three years are going to pass whether you're working on your degree or not. So wouldn't you rather finish those three years with that degree?" And I think that's great advice. Just don't hesitate. If you're thinking about doing something, jump in. Time's going to pass whether you're doing it or not, so do it.

Stewart: I think that's great advice. I went back and got a master's degree years and years later after my undergraduate, and it changed the trajectory of my career for sure. So I think that is great advice. And Sarah, for you, who would you most like to have lunch with, alive or dead?

Sarah: Yeah, I think I got the harder question, but before I joined Asset Management, I was an attorney and I've always been interested in constitutional law and how the constitution was drafted and created. So I'd like to have lunch with James Madison, who was one of the founding drafters, and hear that firsthand account of the process and the conversations that go into that type of process and creation.

Stewart: Wow, that's an interesting answer. No one's ever said that before. That's interesting. So thanks so much. I got a great education today on CMLs and the process and learned about CM-3 loans and all kinds of stuff today. So thanks so much for being on.

Karissa: Thank you.

Sarah: Thanks for having us.

Stewart: We are thrilled. So we have been joined today by Karissa Anderson, head of CML production, and Sarah Swartzendruber, managing director, US Real Estate Asset Management with Aegon Asset Management. Thanks for being on. Thanks for listening. If you have ideas for podcasts, please shoot me a note. It's stewart@insuranceaum.com. Please rate us, like us, and review us on Apple Podcasts, Spotify, Amazon, Google Play, Stitcher, or wherever you listen to your favorite shows. My name's Stewart Foley, and this is the InsuranceAUM.com Podcast.

1 Aegon Real Assets US of December 31, 2023. Please see disclosures for additional important information.
2 MSCI Real Capital Analytics. January 23, 2024.
3 Aegon Real Assets US as of March 27, 2024.
4 As of April 2024. Agency ratings do not reflect favorable client responses or ignore unfavorable client responses. Aegon Real Assets US has paid Standard & Poor's to conduct their rating. This rating is not indicative of future performance. Information regarding Standard & Poor's rating system and criteria is available at www.standardandpoors.com.
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