CORAMERICA
A NASSAU RE COMPANY

COMMERCIAL MORTGAGE DEBT
– AN ATTRACTIVE INVESTMENT STRATEGY

Fourth Quarter | 2016

TABLE OF CONTENTS

EXECUTIVE SUMMARY

Commercial mortgage loans (CMLs) secured by first liens on high quality, commercial and multifamily properties have long been an important investment class for many institutional portfolio investors. These private investments combine a unique blend of characteristics that may provide complementary benefits and meaningful relative value to a multi-asset investment portfolio.

As insurance companies search for the appropriate combination of yield and performance in a low rate environment, commercial mortgage loans should be considered as an ongoing component of a broader investment strategy. Potential benefits of commercial mortgage loans include:

- Compelling relative value
- High recovery rates and commensurate credit loss experience
- Competitive risk-based capital treatment
- Beneficial asset class diversification
- Spread premium resulting in enhanced current income
- Call protection
- Ability to tailor the portfolio to meet specific needs

Although considerable benefits exist, there are inherent challenges related to investing in commercial mortgage loans, including:

- Not publicly rated
- Although a secondary market exists, the investments are not as liquid as certain other investment classes
- Procuring and managing is more intensive, and requires specialized knowledge and systems

DESCRIPTION AND PROCESS

Commercial mortgage loans are fixed income investments that derive their cash flow from the rental income being generated from real estate. As a result, a number of financial and real estate factors must be assessed when evaluating new investment opportunities or when managing these investments post-funding.

An individual commercial mortgage loan is usually secured by a first lien on a commercial real estate asset, typically an industrial warehouse, office, multifamily apartment project, or a retail shopping center. Individually negotiated commercial mortgage loans can be tailored to suit the specific needs of various portfolio and underwriting criteria of a lender as well as the needs of a borrower. The procurement process requires rigorous due diligence and underwriting before any loan can be funded. Appropriate due diligence includes financial analysis of the prospects for the property and the borrower/owner, as well as various third-party reports, including appraisals, environmental reports, engineering reports and other reviews related to insurance coverage, zoning, title, etc. The underwriting criteria, loan-to-value (LTV), debt-service coverage ratios (DSCR) and net operating income (NOI) are critical, but other important metrics are evaluated, depending on the type of property, including the associated micro and macro-economic environment, and its specific location.

These investment opportunities are typically sourced through mortgage banking firms, which are engaged and paid by the owners of the real estate properties to assist in sourcing appropriate providers of real estate capital. It is through this national system of mortgage bankers and brokers that a well-diversified commercial mortgage loan portfolio can be designed and constructed.

Even though commercial mortgage loans have similarities to other fixed income investments, they also have unique structural features that provide additional benefits. These unique features may provide enhanced structural protections and ultimately reduce losses in a default scenario. With commercial mortgage loans, investors usually have a first lien on a real property and more latitude with their approach to servicing issues, as well as more control over the specific approach to various post-closing issues.

Another relevant feature of commercial mortgage loans for insurance company investors is their accounting treatment, which are reported on insurance company balance sheets at amortized cost for both Statutory (STAT) and GAAP accounting. Under GAAP accounting, many companies establish a general reserve for mortgage losses, with a specific reserve established under both STAT and GAAP accounting if an impairment is deemed likely. The current market values of mortgages are provided as a footnote to required regulatory filings. **The table below provides a further comparison between CMLs and public corporate bonds.**

Structural Comparison: CMLs vs Public Corporate Bonds

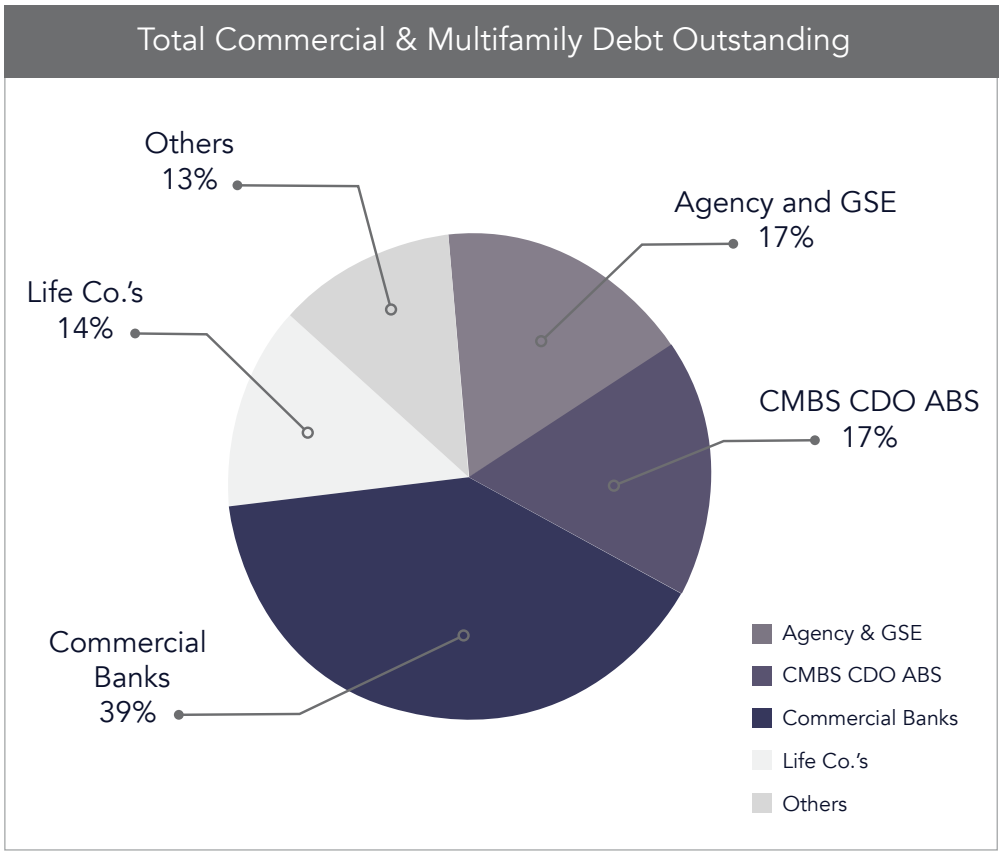
	PUBLIC CORPORATE BONDS	COMMERCIAL MORTGAGE LOANS
Underlying Collateral	Debt obligations of issuer with unsecured claim on corporate assets	A hard asset, commercial real estate property
Repayment Terms	Semi-annual interest payments, balloon at maturity	Typically fixed principal and interest payments monthly with balloon at maturity
Prepayment Protection	Unless callable, typically a make-whole provision to Treasuries	Typically closed for a portion of the term, then a make-whole to Treasuries
Publicly Rated	Yes	No
Recourse	To Issuer	Typically, non-recourse except for certain actions which are guaranteed by a related person or entity
Additional Debt	Limited by bond covenants	Limited by loan documents
Liquidity	Very active and liquid secondary market	Secondary loan market, but not as robust
Sources of cash flow to meet debt service	General cash flow from issuer	Rental income generated from real estate
Ongoing credit monitoring	Quarterly financial disclosures	Quarterly or yearly operating statements and rent rolls for the property
Accounting Treatment for Life Companies	Reported at amortized cost for STAT, held at market value for GAAP accounting	

SCOPE OF COMMERCIAL MORTGAGE INDUSTRY

As of June 30th, 2016 the Mortgage Bankers Association reported total commercial/multifamily debt outstanding of $2.90 trillion. The four major investor group participants were:

- Banks and thrifts (39%)
- Commercial mortgage backed securities (CMBS), collateralized debt obligation (CDO) and other asset backed securities (ABS) issues (17%)
- Federal agency and government sponsored enterprise (GSE) portfolios and mortgage backed securities (MBS) (17%)
- Life insurance companies (14%)

The $407 billion of commercial and multifamily debt held in life insurance company portfolios validates both the importance of commercial and multifamily loans as an investment class and the significant role insurance companies play in the overall real estate finance industry.

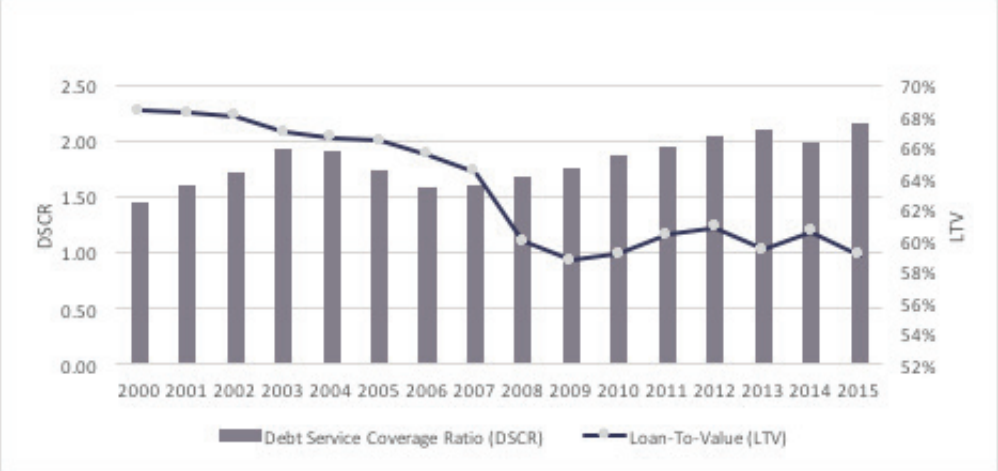


Source: Commercial / Multifamily Mortgage Debt Outstanding Q2 2016

INSURANCE COMPANY PARTICIPATION IN COMMERCIAL MORTGAGES

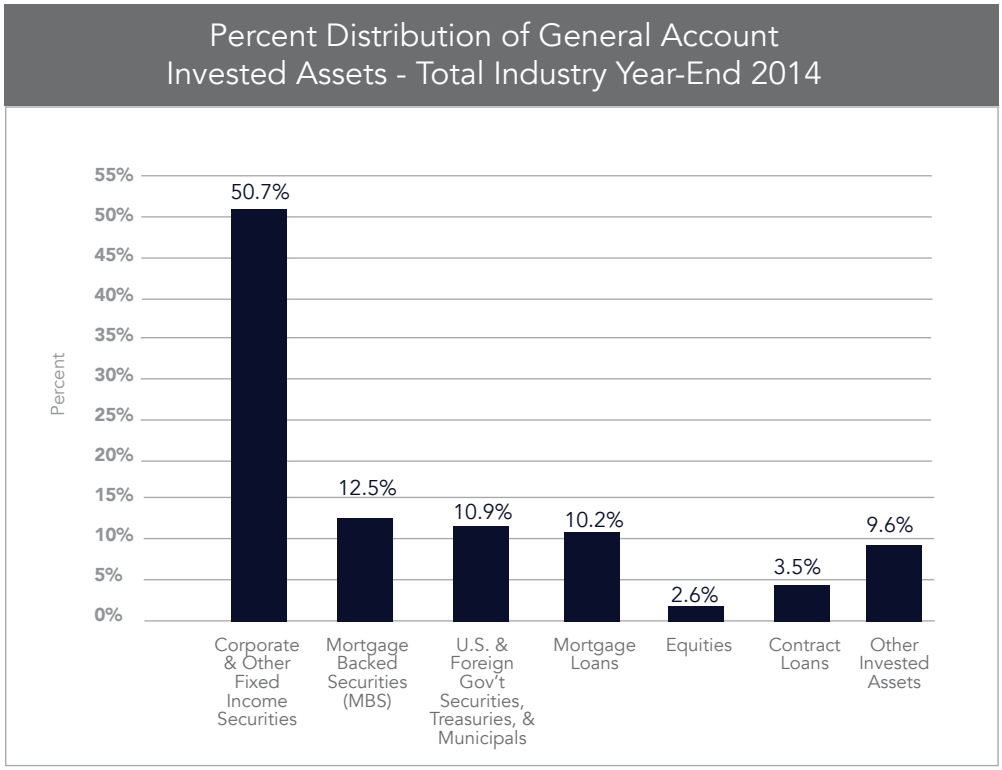
Insurance company lending programs normally target institutional-quality, well-leased properties in major metropolitan areas at moderate levels of leverage. As a result of that conservative investment strategy, insurance companies tend to have the lowest delinquency rates, defaults, and losses within the real estate finance industry. The American Council of Life Insurers (ACLI) data that support the high quality makeup of insurance company portfolios is demonstrated by two common measures of commercial mortgage risk metrics, loan-to-value (LTV) and debt service coverage ratios (DSCR). The ACLI average credit metrics for newly originated loans for the years 2000 through 2015 were 63% LTV and 1.81 DSCR. For full year 2015 the average of those metrics were 59% LTV and 2.15 DSCR.

Average Credit Metrics For Newly-Originated Life Co. Loans



Source: ACLI Commercial Mortgage Commitments

As a result of its various benefits, many insurance companies include commercial mortgage loans in their multi-asset investment mix. According to the most recent information available from the ACLI, on average mortgage loans represent 10.2% of the invested general account assets for the life insurance industry. A number of major life insurance companies hold an even greater weighting in mortgage loans, with percentage exposures in the mid-to-upper teens.

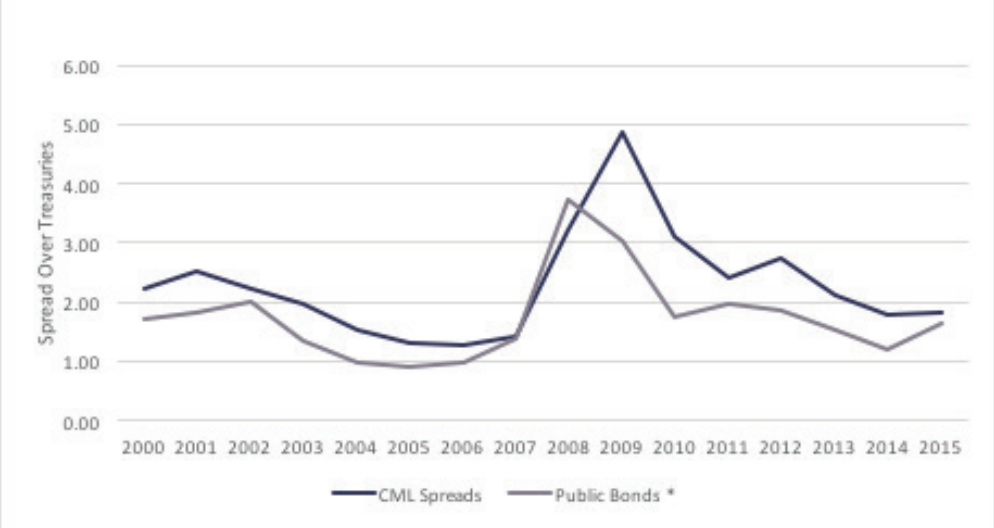


Source: ACLI Invested Assets Portfolio Profile – Year End 2014

PRICING AND HISTORICAL PERFORMANCE OF COMMERCIAL MORTGAGES

Commercial mortgage loans have historically provided yields greater than comparable quality public corporate bonds. The ACLI tracks insurance company spreads above treasuries for new loan originations. The historical ACLI spreads were compared to a composite of similar duration investment-grade corporate bonds from 2000 through 2015. Over that period of time commercial mortgage loans have delivered yields that were on average 54 basis points above this corporate bond benchmark.

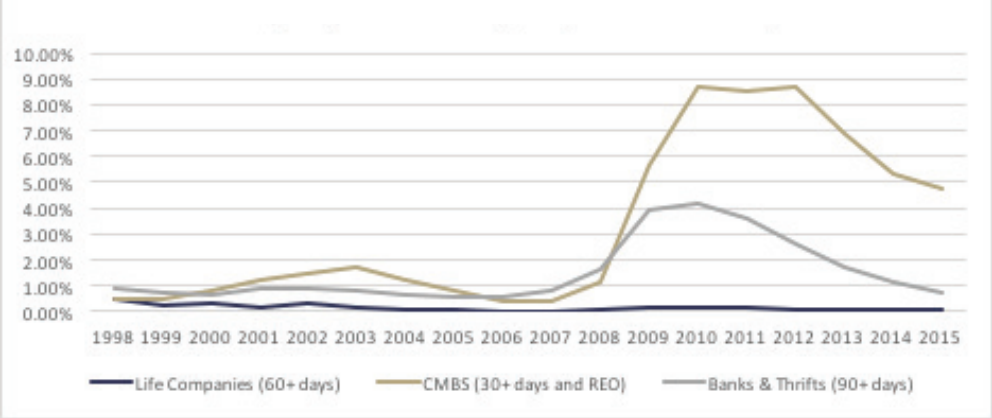
Spread Comparison: CMLs vs. U.S. Corporate Bonds (7-10 Year Maturity)



Source: ACLI Commercial Mortgage Commitments & Barclays US Corporate Index 7-10 Year OAS

Another important measure of commercial mortgage loan performance is historical delinquency rates. The exhibit below graphs life company commercial mortgage loan portfolios against the loan portfolios of two other major investor groups, CMBS and banks & thrifts. Although the various reporting measures of delinquency between investor groups vary somewhat, and thus prevent a direct comparison, the graph does demonstrate the low level of insurance company delinquencies and excellent historical performance of commercial mortgage loans that were generated and held by insurance companies.

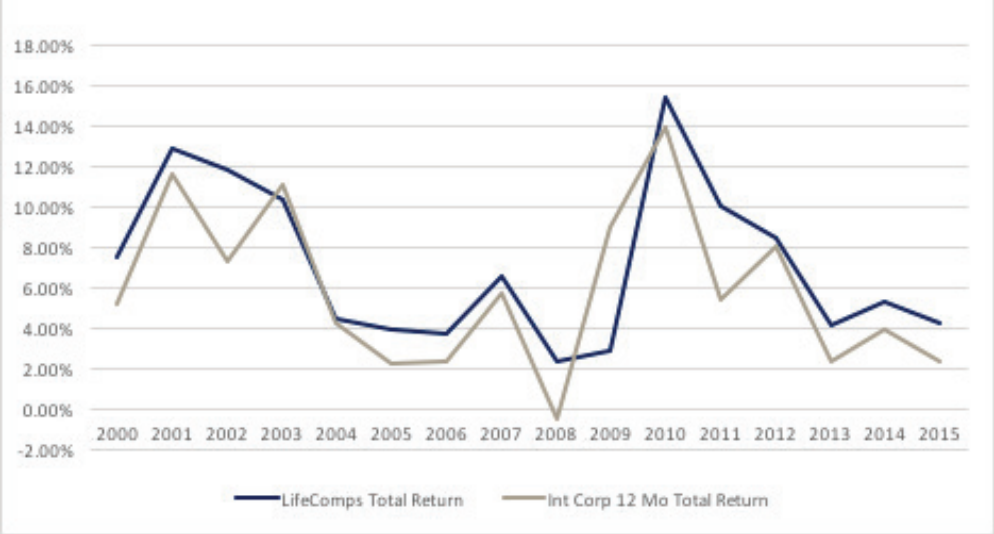
Delinquency Rates Among Major Investor Groups



Source: MBA – Commercial/Multifamily Mortgage Delinquency Rates

Because commercial mortgages are private, non-rated investments, historical performance has traditionally been difficult to measure. However, in an effort to address this issue, a number of major life companies created the LifeComps Commercial Mortgage Loan Index in 1997. The index tracks actual historic returns, including total return, cash yields, underlying real estate collateral operating performance, and basis point loss. The LifeComps data included are reproduced from the LifeComps Commercial Mortgage Loan Index with the permission of LifeComps. This index serves as a performance benchmark for insurance company whole loan portfolios and is the basis for the mortgage loan component of the investment class performance comparison versus intermediate Investment grade corporate bonds. For this comparison the intermediate bond index was selected because it has a nearly identical duration as does the LifeComps index. As detailed below, over the 16-year period from 2000 through 2015 the Average Total Return for CMLs compared very favorably, with an average total return of 7.11% for CMLs versus 5.87% for intermediate bonds.

Total Return Comparison: CMLs vs. Intermediate Corporates



Source: LifeComps Total Return & Barclays Intermediate Corporate 12 Mo Total Return

TAILORING TO MEET INVESTOR NEEDS

Commercial mortgage loan investments allow the investor to exert considerable control both over specific commercial mortgage loan investments and the broader makeup of the mortgage portfolio. Insurance companies typically include amortization of principal throughout the loan term, do not normally allow the loan to be paid off in the early years, and then require yield maintenance protection in the latter portion of the term. Clauses in the documents also prevent the transfer of ownership without lender approval, do not allow additional debt to be placed on the real estate collateral, and provides some level of control over future leasing parameters. These structural issues, combined with the nature of the real estate collateral, allow better control and allow for direct negotiation with the borrower should a problem arise after the loan is funded. These features should ultimately provide for higher rates of recovery than other asset classes without these features.

Many insurance companies construct their portfolios to match their company's liabilities to policy holders. The terms of the mortgage loans typically range between 3 and 20 years, so they are ideal for asset-liability matching for both shorter and longer term liabilities. Another beneficial feature is the call protection embedded in the loan documents. Although there is a relatively high degree of correlation with other fixed income investments, mortgages are not perfectly correlated and do add a degree of diversification to a mixed asset portfolio.

RISK BASED CAPITAL TREATMENT

Because commercial mortgage loans are unrated and somewhat unique investments, there is a distinct process for assessing the risk and assigning risk based capital (RBC) requirements to commercial mortgage loans. In 2013 the National Association of Insurance Commissioners (NAIC) authorized a new risk based capital methodology that focused more on the metrics of each loan and less on the overall historical performance of an insurance company's mortgage portfolio. This updated NAIC process was developed using Moody's analytics and a vast amount of historical data from the insurance company industry. As a result of this analysis, the strong historical performance of insurance industry mortgage portfolios was analyzed, and the resulting overall required capital was actually lowered for the insurance company industry. A 2014 analysis by Fitch indicated that over 92% of life insurers' mortgages were rated as a CM1 or CM2, which are the NAIC's two highest mortgage rating categories.

The required RBC charges for both NAIC rated corporate bonds and commercial mortgages, based upon the current rating methodology, is outlined in the following chart. Almost all new first mortgage loans generated by insurance companies for their portfolios are rated either CM1 or CM2. A CM1 loan has an assigned base capital reserve charge of 0.90% and a CM2 requires a capital reserve of 1.75%. These mortgage charges are similar to capital charges that are assigned for NAIC 1 and NAIC 2 rated public corporate bonds, which

NAIC	CM	RBC	Description*
1		.40%	AAA to A-
	1	.90%	DSC=>1.50x and LTV <85%
2		1.30%	BBB+ to BBB-
	2	1.75%	.95<= DSC <1.50x / LTV<75%
	3	3.00%	DSC<.95x and LTV <85%
3		4.60%	BB+ to BB-
	4	5.00%	DSC<.95x and LTV=>100%
	5	7.50%	DSC<.95x and LTV=>105%
4		10%	B+ to B-

**LTV and DSC metrics covers the office, retail, apartments, and industrial property types.*

CONCLUSION

Commercial mortgage loans are a unique, private asset class that may provide compelling benefits and worthwhile relative value to institutional investors. Many insurance companies consider commercial mortgage loans to be a core component of their investment strategy, and are currently a highly favored investment class by many companies. However, the nuances specific to mortgages and the specialized knowledge and systems that are required to underwrite and manage mortgage loans require the involvement of a capable investment manager.

A meaningful allocation to commercial mortgage loans affords insurance companies the opportunity to improve their investment results, and if not already active in this investment class, should be seriously considered. A whole loan portfolio can be designed to help meet specific needs and allocated to help meet duration, risk, and yield requirements.
