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Environmental, Social and Corporate Governance Investing by Insurance Companies in Real Estate

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In this article, the authors explain why insurance companies investment strategies will include Environmental, Social and Corporate Governance criteria.

Historically, insurance companies have filled a vital role in the U.S. economy by investing heavily in various real estate assets. Such investments have spurred municipal infrastructure improvements and financed the development of commercial, multi-family and agricultural properties. Insurers' longstanding investments in real estate are attributed to their distinct business model that is based on mutualizing and managing risks, which tends to seek opportunities to invest in longer-duration, lower-risk assets that coincide with long-term liabilities—hallmarks of most real estate asset classes.

The ability to hold long-term positions in real estate while simultaneously obtaining liquid premiums from policyholders allows many major insurance companies to invest directly in specific assets as well as in open ended funds.

In fact, many large insurers have established dedicated real estate divisions and asset managers that execute on the acquisition and development of various physical real estate assets, including without limitation, commercial office and retail spaces, industrial buildings and housing.

Insurance companies are also actively engaged in fund investing, such as real estate investment trusts (REITs), which allows for greater access to real estate and the benefit of a diversified portfolio.

ESG CRITERIA

While insurance companies will continue to devote significant funds to real estate positions this year and beyond, evolving economic volatility will compel prudent insurers to pivot on traditional investment strategies. New, innovative investment strategies will necessarily include Environmental, Social and Corporate

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Governance (ESG) criteria, particularly as various stakeholders increasingly expect ESG factors to be a critical component in all facets of business operations, including holdings and ownership in real estate.

ESG investing, which integrates each of the criteria into investment decision making, is complex and nuanced and continues to unfold at breaking speed. From an environmental standpoint, climate change is top of mind and insurers will be pressed to consider energy consumption, renewable or clean energy and carbon reduction when making real estate investments.

There is also a growing appreciation that real estate can have a significant social impact through the form of rehabilitation of public communities, development of affordable housing, or investments in green buildings, with a heightened respect for how society is using residential, office and retail space in tandem with the need to address tenant health and wellness.

Last, but not least, recent regulatory developments are emerging and forcing insurers to meet expectations with transparent actions, further fueling insurers to align real estate investments standards with ESG principles.

DISADVANTAGES OF ESG INVESTING

ESG investing is nothing new, having experienced a meteoric rise in recent years, but one would be remiss to not mention the disadvantages of coupling real estate investments with ESG criteria. The short-term costs associated with implementing ESG, together with increasing regulations and governmental oversight, are becoming so-called ESG risks that can compromise the investment in the underlying real estate.

Stated differently, some institutional investors have been discouraged by ESG mandates.

For example, in May 2019, the New York City Council enacted Local Law 97 (LL97) as the "centerpiece" of the New York City Climate Mobilization Act. This ambitious legislation is aimed at reducing greenhouse gases emitted from many of New York City's largest buildings by 40 percent by 2030, and by 80 percent by 2050, requiring real estate investors to undertake significant and costly upgrades and replacements and introduce green-based technologies in real property. This is but one example of ESG regulatory expectations mandating ESG actions that impose significant obligations, which must be met with equally significant cost outlays.

Despite the underlying good intent of the ESG regulatory environment, some institutional investors may balance risk with reward and ultimately determine that the ESG risks render an investment no longer financially viable.

Insurance companies, on the other hand, generally maintain longer positions in real estate than other institutional investors, and in this regard may recognize that short-term ESG costs will lead to long-term increases in the value of the real property and improvements situated thereon.

Insurers may also look to subsidies and financial assistance available to meet ESG criteria, such as Property-Assessed Clean Energy (PACE) financing, which helps to finance clean energy improvements and mini-

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mize upfront costs. Accordingly, long-term investment strategies complemented with creative financing options may help tip the risk-versus-reward equilibrium.

THE FUTURE

Looking into the future, insurance companies will continue to be a key player role in the real estate industry, but will be compelled to assess and determine how to best manage risk associated with an unpredictable economic environment along with the pros and cons associated with embedded ESG criteria in their real estate investment strategies.

The ESG real estate investing journey is a long one and inescapably requires addressing the needs of regulators, the community and policyholders (among other stakeholders) by achieving a diverse portfolio of real estate assets that generates profits and a return on investment.

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