Spring 2005

Willis

environmental@willis.com

Property Funds – Safe As Houses?

Property portfolios have long been an attractive asset base for funds, offering a relatively "safe" investment generating steady and reliable returns. Property portfolios are not without their risks, however, as local, regional and indeed global economic trends will inevitably affect asset value and revenue returns.

Environmental risks can also present potential liabilities to fund stakeholders, including property owners, fund managers and lenders, and thus ultimately investors. The increasing use of innovative funding mechanisms, such as mezzanine financing (whereby lenders take a share of the fund equity in return for the loan) and securitisation (enabling lenders to trade the debt) potentially increases the risks faced by lenders and debt traders.

Property fund stakeholders, particularly institutional investors, financial institutions and life and pension funds, are typically conservative in their appetite for risk. The "low probability-high severity" nature of environmental risks often clashes with the "zero risk" financial models of such organisations. In today's legislative and business environment, there is simply no such thing as a "clean" site. Environmental risks are notoriously difficult to quantify, verify and manage, often leading to significant perceived risk for even "low risk" funds. Funds that target "high risk" properties in the hope of increased returns following clean-up, are more likely to face liabilities and potential cost overruns as a result of contamination.

Whatever the risk profile of the portfolio, environmental insurance can help by transferring environmental liabilities, enabling fund stakeholders to maintain business objectives, whilst enabling fund managers to maximise property returns.

Case Study – Securitised property unit trust

Background

A property fund was launched to offer investors the opportunity of holding equity interest in property assets through a tax efficient offshore vehicle. The fund was securitised via tradable bonds, a significant proportion of which were debt financed by a major bank.

The fund portfolio comprised approximately 60 tenanted industrial, retail and mixed use properties throughout the UK, which were transferred from an existing portfolio owned by several life funds. Environmental due diligence concluded that environmental issues at five of the properties within the portfolio presented significant potential liabilities.

"Property fund stakeholders, particularly institutional investors, financial institutions and life and pension funds, are typically conservative in their appetite for risk."

Willis is one of the world's leading risk management and insurance intermediaries. We have 14,500 professionals in over 300 offices around the world, all working together towards one goal:

Helping our clients succeed.

Willis Limited, Registered number: 181116 England and Wales.
Registered address: Ten Trinity Square, London EC3P 3AX.
Lloyd's Broker and Member of the General Insurance Standards Council.

MA/2376/09/04
Designed by the Willis Global Design Centre and printed by the Astron Group.

Upon transfer of properties to the trustees, the life funds were required to indemnify the trustees for environmental liabilities associated with such properties. It was agreed, however, that the indemnity would be cancelled in the event that environmental insurance was placed for the five sites to offset such liabilities.

The Solution

Despite the known or anticipated presence of contamination at each of the five sites, Willis was successful in placing environmental insurance to cover the life funds, the trustees and the bank. A separate policy was placed for each property, thus providing a "ringfenced" limit of insurance for each property, which correlated with the environmental consultant's estimates of "worst case" remedial costs. Furthermore, this approach enabled policies to be transferred upon possible future sale of individual properties.

The policy was placed for an initial ten year period, thereby extending beyond the fund life of eight years. However, a "rolling renewal" facility was also agreed with insurers whereby the policy could be extended annually, providing the insureds, and ultimately the individual investors, with the assurance that long term cover was maintained beyond the life of the fund, enhancing the value of the properties upon fund closure.

As the properties were all tenanted, a key risk exposure was the potential loss of rental income in the event of clean-up works, for example due to the need to relocate tenants. Coverage was expanded to cover such losses, Willis working closely with lawyers representing life funds, trustees and the bank to negotiate policy wording with the insurer.

The Benefits

Through the use of environmental insurance, the life funds were able to maximise the transfer value of the properties to the new fund, whilst also cancelling the indemnity originally provided. The trustees gained the certainty of cover for identified "problem" sites, whilst the bank was able to protect both its direct risk (as equity holder) and indirect credit risk.

David Barr
Project Director (author)

David joined Willis after gaining 13 years experience in the petroleum industry and environmental consultancy field, specialising in the provision of environmental due diligence, risk assessment and financial modelling services to the property and corporate sectors. David's practical and technical knowledge of environmental risk management has further enhanced Willis' capabilities in delivering innovative and bespoke risk transfer solutions for environmental liabilities.

United Kingdom
One Camomile Street
London
EC3A 7LA
Tel: +44 (0) 20 7975 2481

USA
7 Hanover Square
New York
NY 10004-2594
Tel: +1 212 344 8888

France
Gras Savoye
2 a 8 rue Ancellle
Neuilly Sur Seine, Paris 92202
Tel: +33 141 43 50 00

Spain
Paseo de la Castellana 36 – 38
4a Planta, Edificio Castellana
Madrid 28046
Tel: +34 91 423 3400

Germany
Gruneburgweg 102
Frankfurt au Main 60323
Tel: +49 69 95931-0

Italy
Via Speronari 8
Milan 20123
Tel: +39 (0) 2 80 63 21

Sweden
Mäster Samuelsgatan 6
S-11144 Stockholm
Tel: +46 8 463 8900

Netherlands
De Ruyterkade 7
Amsterdam 1013 AA
Tel: +31 20 531 2525