"How does SL AM approach real estate risk management? What are the most important challenges and how are our competitors dealing with this topic?"

KPP Class of 2017 Finance Module

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Looking back on the financial crisis, it becomes clear which factor is increasingly gaining in importance: risk management. Both in investment and in asset and property management, managers such as Swiss Life Asset Managers, are increasingly dealing with the measurement and monitoring of risks and the analysis of loss potential.

To get a deeper understanding of real estate risk management at Swiss Life, I conducted an interview with Annelis Lüscher Hämmerli (CRO Swiss Life Asset Managers), Prof. Dr. Marion Peyinghaus (Managing Director CCPMRE GmbH) and Yvonne Bosilj (senior expert in risk and process management at Swiss Life Asset Management GmbH).

Florian Bauer: Which market developments and/or trends are, in your view, driving the need for real estate risk management?

Annelis Lüscher Hämmerli: Real estate was and is – today, in the ultra-low yield environment, more than ever – a sought-after investment class for its risk-return profile and for the possibility of having a regular income flow and possible capital gains. Real estate also takes up a significant portion of Swiss Life's invested balance sheet assets (PAM) as this asset class offers attractive returns relative to its risks and is a capital-efficient asset class under the solvency requirements. Moreover, third-party clients (TPAM) searching for attractive risk-adjusted investments in the alternative asset universe rely on our real estate propositions and our risk management expertise therein.

Thus, I believe that the main reason for real estate risk management lies in the very nature of our business and is driven by the internal and external requirements we are expected to fulfil. Highly professional asset and portfolio management for our PAM and TPAM clients has to be backed by efficient risk management and risk oversight to reach targets. In addition, the need for higher reporting standards and increased transparency for internal and external stakeholders, more extensive risk information requirements from the management, due to the fast growth of our AuMs and growth of our division, for quick risk analytics and the overall amount and availability of data are recent market developments. Of course, the very positive market trend we have seen in recent years with increased demand from investors for real estate investments are pushing risk management activities.

Marion Peyinghaus: In my view, there are three main reasons: the first is market-driven, the second is based on digitisation and the last one comes from the regulation side.

Firstly, the real estate markets have developed steadily in recent years. In addition, there is a lot of investment capital in the market. Therefore, investment properties are highly competitive. Investors are therefore forced to pay an increased purchase price or to switch to other risk classes. For this reason, risk systems that detect market changes or risks in real estate at an early stage are urgently needed. Due to the globally networked markets, however, these market changes can also be triggered by causes outside the real estate world (e.g. interest rates, politics). Risk management encompasses these external factors.

The second reason is based on the current euphoria about digitisation. Almost every company is currently investing in its IT landscape. IT systems and reports are experiencing an enormous upswing. However, the quality of the data is often neglected and also the limits of knowledge gained through data. IT systems also offer a target. Data can be manipulated, for example. Therefore, the belief in technology should be contrasted with risk management.

The third reason for risk management tools is simple: more and more institutions and supervisory authorities are demanding risk reports. We therefore need tools to deliver these reports efficiently.

What are the key elements of real estate risk management and how can risks be monitored effectively?

Annelis Lüscher Hämmerli: Risk management at AM division level is dedicated to providing proactive guidance and implementation for risk processes, governance and risk principles, in order to strive, as a company, towards a best-in-class risk culture. Depending on the decision level, either local risk management or the CRO office is involved in providing a second line risk assessment, for example, for new collective investment schemes or project development proposals. Special care is taken in order to support the requestor of such a proposal in identifying and assessing the inherent risks, developing mitigation measures and then after approval of the request to manage the identified risks. Swiss Life AM stands for a risk culture not of risk avoidance but instead of taking and managing risks that are well understood and for which the expected return compensates the shareholder adequately.

Regular risk reporting and risk reviews are part of our monitoring process for the existing real estate portfolio and project developments. As a result, detailed and good data quality but also a global data management process are key to identifying risks through a holistic approach.

Marion Peyinghaus: Effective risk management requires three cornerstones: a structured process, clearly assigned roles and a powerful IT system. The process ensures the regularity and consistency of risk identification, its evaluation and subsequent risk reduction. Clear roles are needed to give weight to risk management. It is therefore advisable to anchor risk management at management level. The risk management system should be closely linked to real estate-specific data. Data from the real estate systems can be transferred to a separate risk tool or risk functions can be integrated directly into the real estate management systems. The more closely risk management is linked to real estate management the sooner risks can be identified. This applies to all three levels: processes, organisation and IT.

Which risk categories are used in real estate risk management (@ Swiss Life AM / @ SLAM Germany / in general)?

Annelis Lüscher Hämmerli: Based on our risk charter we have defined a risk management framework and risk categories, which are based on the enterprise risk management (ERM) framework of Swiss Life Group. Swiss Life distinguishes between quantitative and qualitative risks. Risk categories such as market, credit, liquidity, insurance and concentration risks are counted as quantitative risks, whereas operational, strategic, reputational and emerging risk are of a qualitative nature.

For real estate portfolios more specifically, we consider additional categories such as relevant location, property condition, real estate investment risks and yield requirements and want to pay special attention to concentration risks across all our on- and off-balance sheet real estate assets.

How does the differentiation work between risks of the asset management organisation itself and risks relating to the managed real assets in the PAM and TPAM business?

Annelis Lüscher Hämmerli: Within Swiss Life Asset Managers and Swiss Life Group we have three lines of defence. The first line of defence is the operational business units, the asset and portfolio managers for example, which are not only responsible for a good return but also for risk management on a day-to -day basis. The risk taker at Swiss Life AM is also always the risk owner and therefore the most important risk manager.

The AM Divison Risk Function with all its risk teams in all the local units as the second line of defence is, besides providing the risk framework, responsible for the identification, analysis, monitoring and reporting of all the risks and coordinates with the responsible head of risk in the legal entities. In addition, the second line provides guidance and teaching on risk-related matters to the first line and intensively supports the first line in the identification and analysis of risks and their mitigation measures. In addition, risk management at Swiss Life AM differentiates between the clients, i.e. PAM and TPAM, quantitative risks (investment risk) and SL AM's risks, such as strategic, operational or reputational risks.

The third line of defence is the independent assurance of the effectiveness and efficiency of the risk management process and includes internal and external audit.

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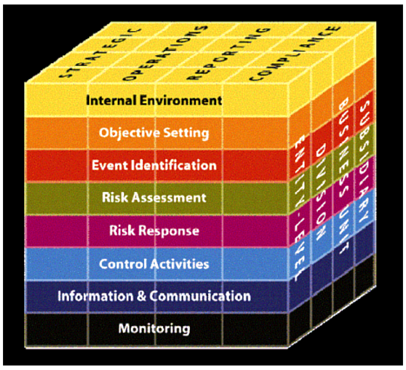
Yvonne Bosilj: SL AM Germany uses risk categories based on the risk catalogue according to COSO (Committee of Sponsoring Organizations of the Treadway Commission) or the extension COSO ERM-Framework, which represents the internationally recognised standard for company-wide risk management.



We work with the four main categories and their subcategories:

- Strategic: high-level goals, aligned with the company's orientation
- Operations: effective and efficient use of resources
- Finance: all cash flows
- Compliance: compliance with legal and regulatory requirements

In the Real Estate division, the focus is primarily on operational risks. Therefore, a further subcategory "property risks" has been added to reflect the special risks of the individual properties.

Marion Peyinghaus: The risk categories vary from company to company and are determined by the business model and the real estate portfolio of the respective company. Classic risks are portfolio risks and property risks. Portfolio risks relate in particular to concentration phenomena, such as a lack of diversification in types of use, regions or property types. Property risks mainly comprise the topics of letting and maintenance. Depending on the business model, financing or foreign currency risks are also highly relevant. However, it is equally important to identify risks associated with the company itself. These entrepreneurial risks include, for example, wrong strategic decisions, process failures, loss of competence due to redundancies or quality failures at service providers. When drawing up a risk list for the first time, all risk areas should therefore be checked for their relevance and evaluated from a 360-degree perspective.

Is there a differentiation in risk management for PAM and TPAM?

Annelis Lüscher Hämmerli: In general, there is no differentiation in how risk management is defined and organised. Content-related there are of course differences regarding the asset and risk management and specific requirements of PAM or TPAM mandates.

For example, for the PAM business, SL AM seeks to take risks inherent to the asset management business and with which we can earn the cost of capital. A risk-based limit framework and measures such as statutory solvency, SST ratio, drive all investment decisions or IFRS P&L are taken into account.

For TPAM we act as a fiduciary in the interests of our clients. Typically, TPAM mandates and products are managed vs. benchmark, whereas PAM assets are managed on an absolute basis. However, most importantly, with respect to investment risks SL AM ensures that the implementation of the clients' mandates, be it PAM or TPAM, fits with the clients' risk appetite and expected return, which may lead to a different focus for risk management for different client groups.

What kind of systems and tools are used to perform real estate risk management?

Annelis Lüscher Hämmerli: There are several systems and tools used in the local business units. At AM division level, we currently do not have a holistic system or any tools to run risk analytics for the Group-wide real estate portfolio. A central real estate database is required to efficiently create real estate risk reports and define comparable key risk indicators.

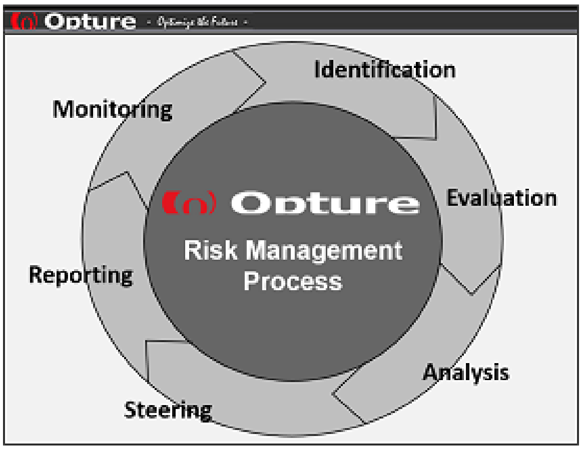
Yvonne Bosilj: For the real estate division of SL AM Germany, we currently use the ERM Basic Tool from Opture AG, one of the leading system providers in the ERM sector. This module is the first of three successive software solutions (Basic, Advanced, Expert version). With the Basic version it is possible to picture the complete risk management process. All relevant risks as well as mitigating measures can be described systematically in a bottom-up approach. Furthermore, a series of meaningful reports can be produced quite easily, which are used in local risk committees as well as in daily operations by our portfolio and asset managers.

A great advantage of this software solution is that it offers individual configurable features, so that it could be easily adapted to our needs without the need for customising by the software provider. Furthermore, existing configurations can be supplemented, extended and adapted by our internal system administrators.

How is real estate risk management performed for the real estate portfolio of Swiss Life Germany?

Yvonne Bosilj: Ideally, the complete risk management process is incorporated in the respective tool/software solution used, which is the case with the Opture ERM basic implemented by SL AM Germany. As part of risk identification (carried out by our real estate asset managers), the risks and measures are identified and evaluated based on a predefined risk catalogue that was adapted to the needs of SL AM. The risk analysis, followed by the risk assessment, enables the risk manager/risk owner to realise effective risk steering. After defining the risk mitigation measures (including respective costs of those measures), the risk results are graphically presented and documented in one or more risk reports that can easily be designed by our local team. Risk monitoring, which is performed by our real estate portfolio managers as well as our SL AM risk department, continuously controls the development of individual risks and risk exposures.

Our risk management process for real estate investments of Swiss Life Germany foresees a monthly update of all identified risks as well as mitigating measures combined with monthly reporting to our local risk committee. Moreover, real estate portfolio managers monitor the development of risks on a monthly basis and discuss them with their local asset managers.



A very significant aspect of our risk management process is communication and coordination between the various specialist departments (commercial and technical asset management, real estate accounting and portfolio management) regarding potential risks. It is crucial that this takes place in a structured way and on a regular basis.

Through the implementation of a comprehensive risk management software and a corresponding process, we were able to achieve much greater transparency regarding risks in our real estate portfolio and are now able to implement mitigating measures at an earlier stage than before. As a result, we hope to achieve better investment results for our client Swiss Life Germany.

What are the key elements of real estate risk management reporting?

Annelis Lüscher Hämmerli: A real estate risk management report should be "as simple as possible and as complicated as necessary". I believe that efficient reporting should be customised for the management, reader-friendly and focus only on relevant information. Minimum requirements, key risk indicators and risk analytics should be predefined so that all risks can be identified at an early stage and at best before risks materialise. It is therefore important that reports should be easily comparable over the reporting periods. Risk analytics should at least consider risks on property and tenant level with a focus on concentration risks but financial, liquidity and operational risks, such as physical or functional obsolescence should also be part of it. Moreover, it is my belief that we should never stop thinking out of the box and therefore I am currently, for example, evaluating how (and if) we should analyse the effect of unpredictable weather (which seems to be increasing) such as floods or rising sea levels on our real estate portfolio.

Which risks are currently of relevance and how can market participants protect themselves?

Marion Peyinghaus: As already indicated above, in my view the two main risks lie in the real estate markets and in digitisation. For the real estate markets, tighter risk management in acquisition and greater attention to portfolio diversification will help. In addition, risk management processes should be closely linked to real estate processes to identify risks at an early stage. For example, risks in the retail sector have been announced for the long term through increased online shopping. However, in the event of entertaining economic fluctuations, this could immediately have a negative impact on investor capital for start-ups. This would also lead directly to a vacancy rate for coworking areas. Risk management should be able to point this out. The risks of digitisation are gradually reduced by the companies themselves, but also by external influences. One of these influencing factors is the new data protection regulation. This policy forces companies to appoint a data protection officer, critically review their own data and protect themselves from external system risks.

Where do you see the biggest challenges for Swiss Life AM in real estate risk management in the next few years?

Annelis Lüscher Hämmerli: We have recently developed our Target Operating Model for real estate risk and have introduced dedicated risk functions at AM Division level and in the local business units. Moreover, the risk function will be part of the new product process for real estate and we have started to conduct risk review meetings on a half-yearly basis. Swiss Life AM's strong growth in real estate and the fact that the investment strategy foresees a further strengthening of the real estate activities in expanding its TPAM business makes it necessary to keep pace and strengthen our risk management activities. The exchange between AM Division and the local real estate heads and their risk managers will continue and further deepen. The main challenges will be the development of a central and Group-wide real estate database allowing us to take the necessary holistic approach to risk management.