Solvency II and real estate funds

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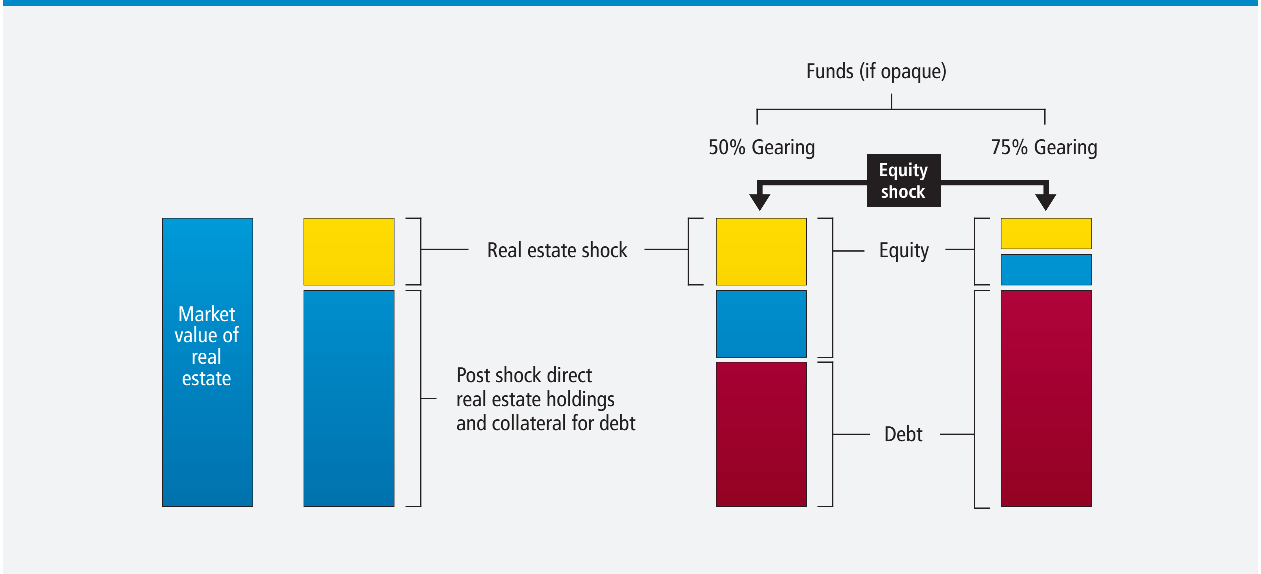
The implementation of the Solvency II regulations for European insurance companies is of huge significance for the real estate industry. Life insurance companies are major investors in real estate funds. Furthermore, the European Insurance and Occupational Pensions Authority (EIOPA) has a consultation process running until January regarding the extension of a Solvency II type regime to some or all defined benefit pension schemes. This will potentially have an even greater impact for the real estate industry than the application of the rules to insurance companies.

The implementation process by the European Union is now reaching the point where much greater clarity is expected. The Level 2 regulations have now moved from the EU Commission to the EU Parliament. Although the Level 2 regulations are not a public document, they appear to have been circulated quite widely and have been commented upon in the real estate trade press. Many people have already commented on the broader implications for the real estate industry of changes in the attitude of life insurance companies to real estate as an asset class as a result of the anticipated Solvency II changes. This article concentrates on the impact for real estate funds.

The key concern for real estate fund managers is how insurers and possibly pension funds will view indirect investment in real estate as an investment asset once Solvency II is in force, and in particular, how they will be required to model potential future falls in value of their investments. Insurers can either use a 'standard model' for which the risk factors are set down by the EU regulator or seek approval from their national regulator to use their own internally generated risk model. Much of the real estate industry attention has focused on the amount by which insurers need to write down the value of their real estate investment assets under the standard model. Currently the proposal is that the shock to be applied to direct real estate investments is 25%, i.e. insurers should write down the book value of their real estate investments by 25%, from a starting point that the assets are carried in the books at market value. For the vast majority of major life insurers, the use of the internal model is more relevant. However, the smaller insurers, who could be investors in funds, may be relying on the standard model. Furthermore, if a similar approach is adopted for defined benefit pension schemes, which are generally less sophisticated than major insurers, use of a standard model is likely to be more prevalent.

The treatment under Solvency II of real estate investment through funds is still also unclear, although it is widely believed that the proposals that have gone from the EU Commission to the Parliament provide much greater clarity. This will be welcome news for real estate fund managers. The lack of certainty has been a major concern as it has been encouraging insurers to delay deploying capital with real estate fund managers. For un-geared funds, it has always been understood that they should be treated as if the assets were held directly, i.e. the 25% write-down should be applied. For geared funds, the position had been less clear. Previous commentary has implied that the equity shocks should be used. These are 49% for unlisted vehicles and 39% for listed (subject to an adjustment of up to 10% either way intended to smooth the impact of fluctuations in equity markets). However, it should be noted that these shocks are applied to the net value of the equity whereas

Figure 1: Solvency II shock calculations for real estate under standard model



the 25% for property would be applied to the gross value before gearing, as illustrated in Figure 1. The equity shocks are also adjusted depending upon the state of the market at the time, through the mechanism of the dampener. Insurers and fund managers need to know whether funds should be treated as transparent and thus as real estate investments or opaque as equity investments.

Real estate funds cover a broad spectrum; the nature of the investment vehicles varies considerably, as does the way in which they are financed, the level of gearing and indeed the nature of the underlying investments. For an open-ended vehicle, with low levels of gearing and core real estate as the underlying asset, the transparent treatment would seem most appropriate. At the other end of the spectrum, a closed-ended real estate private equity fund with high levels of gearing and underlying assets with significant operating risk, for example hotels, is difficult to distinguish from any other form of private equity fund. Choosing either approach and applying it to all real estate funds would seem inappropriate for one end of the spectrum or the other.

Defining some form of segmentation through regulation is unlikely to be successful. Many eminent figures and organisations in the real estate industry have attempted during the last decade to adequately define different fund styles and strategies with only partial success. It would seem unlikely that the insurance regulator would be better placed to come up with a sensible approach. The most obvious option would be to allow insurers to decide on a case by case basis which of the two approaches is most appropriate, taking into account the characteristics of the underlying investments. Commentary in the industry suggests that the Commission is moving towards a default approach of following the 'look-through' approach for all indirect exposures, including exposures to geared funds, and this is certainly what is reflected in the proposed reporting regime in the consultation paper issued recently by EIOPA discussed further below. Speculation is that although a transparent approach will be the default option under the proposals that have gone to the EU Parliament, insurers will be allowed to adopt the equity treatment in cases where the transparent treatment would be inappropriate or impractical. Although there is some uncertainty as to what this would mean in practice, this would be a welcome outcome as it will provide the flexibility advocated above. There is some contradiction in a look-through approach being adopted for all funds, whilst at the same time specifically stating that private equity and hedge should be treated as unlisted equity. It is also unclear how much attention has been given to the fact that very many funds are structured with holding companies and special purpose vehicles, so a look-through approach, if it is only at the fund level, does not necessarily provide the comprehensive answer suggested by some commentators.

The 25% market shock also affects the way that real estate debt is treated in the books of insurers. The standard formula currently requires that, for loans secured by a mortgage, the value of the collateral is written down by the standard shock. This potentially makes secured real estate lending a more attractive proposition than direct real estate investment as the owner of the equity is assumed to suffer the brunt of the shock with the lender only suffering once the adjusted value of the collateral is lower than the amount of the loan. Pressure on other traditional lenders to reduce their commercial property lending is creating an opportunity that is attractive to insurers from both a commercial and a regulatory perspective.

If the uncertainties regarding the treatment of funds can be resolved, there are compelling arguments for insurers to reduce their investment in direct property, but at the same time to increase their exposure to real estate debt and to higher return real estate investments. Real estate debt provides the lower risk element and has a relatively more favourable treatment under Solvency II. Fund and direct investments have a much more capital hungry treatment under Solvency II but provide the potential for upside if the investment is in higher risk / higher return assets. The blended effect gives a better Solvency II result than holding large swathes of direct property delivering not much more than a bond-type return. The high capital cost of investing in real estate other than through debt has to be justified by higher returns.

Aside from the fundamental question as to whether Solvency II will change the behaviour of insurers and pension funds in the way they perceive real estate as an asset class, fund managers and others will also need to address the reporting implications. This is again an area of uncertainty. EIOPA published its 'Consultation Paper on the proposal on Quantitative Reporting Templates' and 'Draft proposal for Guidelines on Narrative Public Disclosure & Supervisory Reporting, Predefined Events and Processes for Reporting & Disclosure' on 8 November. This is a consultation due to run until 20 January 2012, after which EIOPA will consider the feedback received and expects to finalise the package in summer 2012. These snappily titled documents are a significant step forward in the process that will determine the public and supervisory reporting obligations of the insurers, which will in turn determine the level of granularity of reporting at the fund level. As indicated above, the assumption is that funds will be treated as transparent so reporting will need to be in respect of the underlying investments of the funds.

The FSA has this month also launched its own consultation process in respect of implementation of Solvency II in the UK.

Solvency II is clearly going to be a major challenge for the real estate fund management industry, but also potentially a stimulus for product development. This should become considerably clearer over the next two months. The move towards flexibility of treatment of funds would be a very welcome development, if this is what emerges from the EU Parliament.