Investment Property Forum
Hana Workspaces
70 St. Mary Axe
London EC3A 8BE

email ipfoffice@ipf.org.uk web www.ipf.org.uk

Sue Forster
email sforster@ipf.org.uk tel 07880 729624

Response by email to SolvencyIIReview@hmtreasury.gov.uk

20 July 2022

HM Treasury: Review of the Solvency II Consultation

The Investment Property Forum (IPF) welcomes the opportunity to respond to the above consultation.

The IPF is a national membership organisation of senior professionals, all active in the property investment and finance market. The organisation has a diverse membership of nearly 2,000, which includes fund managers, investment agents, accountants, bankers, lawyers, researchers, academics, actuaries and other related professionals.

The IPF's Mission is to enhance the understanding and efficiency of property as an investment, including public, private, debt, equity and derivatives, for its members and other interested parties, including government. We are not a lobby organisation but one of our key priorities is to identify where legislation or regulation has, or will have, an impact on the market and to alert government and our members to any adverse or beneficial issues.

IPF response

Prior to the introduction of Solvency II on 1 January 2016, the IPF was heavily involved in the real estate industry organisations' discussions with EIOPA of the treatment of real estate. This has been of concern to us since then, given that the methodology used by EIOPA calculates the solvency capital requirement on the most extreme expected losses over the course of a single year, which is too short a duration for illiquid assets such as real estate. We believe that the current consultation is ideal opportunity to revisit this for UK insurers.

Several real estate trade associations, including the IPF, have prepared a paper (see Appendix) that sets out a collective view on the issues arising from the Solvency II treatment of investments in real estate and infrastructure.

As set out in the paper, the current methodology- modelling the volatility of real estate on a one-year basis - overstates the risks on the asset side of the equation for long-term assets held to match those liabilities. This is particularly the case for real estate and infrastructure. The result is that this may distort life insurers' investment decisions, discouraging investment in illiquid assets, and, consequently, undermining other government policy initiatives, including financing of the real economy and green transition, along with levelling up the regions.

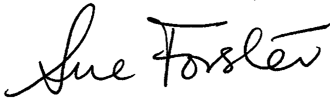
The existing UK real estate stock will require huge levels of investment in the coming years if the UK is to meet its Net Zero commitments. Life insurance companies being deterred by inappropriate capital charges will not help in this regard.

VAT No: 677 9801 73

Registered address:
2nd Floor, 2 City Place, Beehive Ring Road, Gatwick,
West Sussex RH6 0PA.
Registered in England 2763992.

IPF Investment Property Forum

Please do contact me should you wish to discuss any of the above in further detail.



Sue Forster
Chief Executive, Investment Property Forum

Appendix: **Paper written by a Working Group**

Response to HM Treasury's consultation on Solvency II

This response has been developed by a working group consisting of representatives from the Association of Real Estate Funds (AREF), British Property Federation (BPF), IPF, INREV and other real estate experts, in liaison with the representatives from the Association of British Insurers (ABI) and the Investment Association (IA).

July 2022

Introduction

The real estate investment industry strongly supports the Government's decision to undertake a review of Solvency II. In particular, we welcome the recognition in chapter 2 of the consultation of the fundamental difference between long-term life insurers and general insurers. Although the proposal in chapter 2 is a substantial reduction in the risk margin on the basis that the current methodology can overstate the market value of a firm's liabilities, we believe the current methodology also overstates the risks on the asset side of the equation for long-term assets held to match those liabilities. This is particularly the case for real estate and infrastructure. We believe that this distorts life insurers' investment decisions, discouraging investment in illiquid assets, and therefore undermines other government policy initiatives including financing of the real economy and green transition, along with levelling up the regions.

Chapters 3 and Chapter 4 of the consultation look at increasing investment flexibility but both chapters are focused on assets and liabilities within the narrow definition of the matching adjustment. While changes to the matching adjustment are important, we also believe that changes are needed to the treatment of long-term assets that fall outside the matching adjustment.

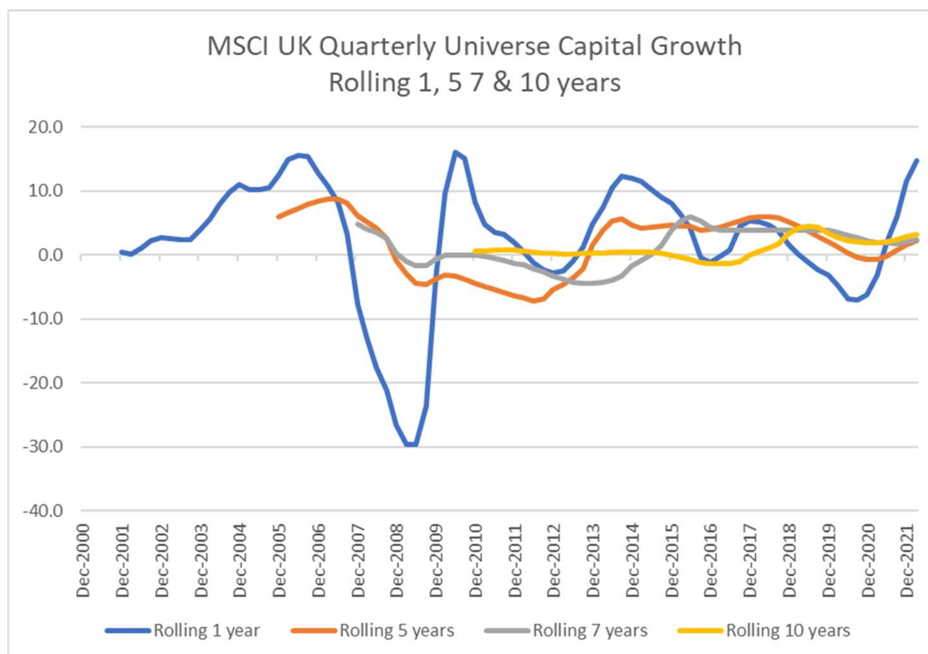
The EU Solvency II Directive as entered into force on 1 January 2016 did not distinguish between long-term life insurers and general insurers. A significant consequence of this was to treat all investments as short-term and potentially available to meet the short-term liabilities of general insurers. EIOPA recognised the inherent flaw in this model and attempted, with only partial success, to address this through the creation of the long-term equity (LTE) category set out in Article 171a of Solvency II Delegated Acts of 2019. We believe that further changes are needed to these provisions and that an equivalent change is needed to the Solvency Capital Requirements (SCR) charge for property to bring it in line with the LTE category. Prior to the

introduction of the LTE category, all equities were subject to SCR charges based on short-term volatility. For listed equities this was 39% and for unlisted 49%. There is a volatility dampener of +/- 10%. For equities falling into the LTE category, the SCR charge is now 22%; however, there are a number of conditions, the key one being that the equities are to be held for more than five years. It is important to note:

- For equities within the LTE category, there is no distinction between listed and unlisted equities;
- Because the longer time period results in a smoothing of the volatility, there is no volatility dampener for LTE equities as this becomes unnecessary; and
- The 39% and 49% remain for equities falling outside the LTE category.

Despite the changes to the LTE category, the SCR charge for property risk of 25% is unchanged from the original EU Solvency II Delegated Act assumption of a worst-case short-term downside scenario (Property risk sub-module, Article 174). However, a review by EIOPA of insurers' average holding periods for the assets identified as long-term holdings suggests that these are considerably longer than for the total portfolio, with real estate (including funds) having the longest average holding period of 14 years[1].

The 25% SCR charge for property risk was based on MSCI data for real estate investment in the United Kingdom. Using MSCI data over 5-year, 10-year and 15-year periods, rather than one year, gives very different outcomes. Holding periods are important in the context of the expected maximum value at risk in real estate portfolios. While the UK market, as measured by MSCI, experienced a fall in capital values of up to 30% over 12 months during the Global Financial Crisis, the largest per annum value declines over longer hold periods are much reduced. As the data below show, an assumed hold period of five years mitigates much of the value decline in any one year, and with a ten year hold period the annual value decline is minimal.



MSCI UK Quarterly Universe CAPITAL Growth Rolling 1, 5, 7 & 10 years
Source: MSCI Quarterly Index March 2022

[1] See: https://www.eiopa.europa.eu/content/insurers-asset-and-liability-management-relation-illiquidity-their-liabilities_en

IPF Investment Property Forum

Life insurers invest in real estate through a variety of routes, including direct property, investment in funds, real estate debt and listed real estate companies, particularly REITs. We believe consideration should be given to changes to Solvency II in each of these areas, as set out later in this submission. We also believe that it is important to recognise that investments in real estate can cover a very broad spectrum. Using the property shock, subject to the proposed change in its calculation, may not be appropriate for either end of the spectrum. At one end of the range, highly leveraged investments in real estate with substantial operational element, for example hotels, would appear to be closer to private equity. At the other end of the range, property on a 25 year lease to the government, would appear to be closer to a bond eligible for the matching adjustment. These points are reflected in our proposals below.

Why is investment in real estate important?

We believe that removing impediments to investment in real estate and other illiquid assets is important from the perspective of insurance companies and also broader government policy initiatives:

- For life insurers, real estate has always been an attractive asset class due to its liability matching characteristics and predictable income streams in the form of rents. Recent years have seen a significant broadening of the asset base with life insurers investing in:
    - Residential property alongside the more traditional allocation to commercial real estate; and
    - Infrastructure sitting alongside traditional real estate in a broader "Real Assets" approach.
- As identified in the consultation, part of the objective is to unlock tens of billions of pounds for long-term productive investments, including infrastructure. A key component of the government's levelling up mission is encouraging very large-scale institutional investment in regeneration, infrastructure and housing across the UK.

The current SCR charges for those using the standard model actively discourage this.

Our proposals

We believe a number of changes would improve the treatment of real estate and infrastructure. Our comments largely relate to the treatment of market risks under the standard model for Solvency II, which is outside the specific questions posed in the consultation. Although we understand that the majority of UK life insurance companies have their own internal models approved by the PRA, the methodology follows that set out in the EU Solvency II Directive, which we believe to be fundamentally flawed. We understand that some UK life insurers who have their own internal models approved by the PRA use standard model volatility for real estate and equities. We therefore believe that changes to the standard model are important.

<u>Property SCR charge</u>

As outlined above, modelling volatility of real estate on a one-year basis does not reflect the commercial reality of life insurance investment in the asset class. We are therefore proposing a reduction in the current SCR charge for property risk from 25% to 10% or below. This is consistent with the reduction in equity volatility for long-term equities. We also believe that some long lease real estate investments be eligible to be within an expanded matching adjustment. This is discussed further below.

<u>LTE category assets</u>

We believe that the current conditions on the LTE category of assets are designed to ensure that they are only held to match long-term liabilities in a typical life insurance business. However, the conditions as drafted are difficult to apply in practice, particularly for private equity. The proposed UK approach of having provisions that apply only to life insurance companies would be a far better route to determining the eligibility of assets for the

LTE regime than the specific requirements in the current EU Solvency II Directive. We believe that the treatment of private equity is relevant for some funds investing in real estate, as we believe some funds investing in real estate should more appropriately be treated as private equity funds. This is discussed in “treatment of funds” below.

Treatment of funds

Funds investing in real estate are treated on a look-through basis with the property SCR charge applied to the gross value of the underlying real estate. While this is appropriate for “core” funds, investing in traditional stabilised assets with low levels of borrowing, there are other real estate (and infrastructure) funds that are much closer in character to private equity funds. Life insurers should have the flexibility to decide on a case-by-case basis whether a fund should be regarded as property (real estate fund) or long-term equity (private equity fund). In view of some of the practical issues that have arisen in trying to set rules for eligibility for the LTE category, we think that insurers are better placed to make this assessment than trying to set pre-determined tests in the regulatory framework.

Real estate debt

Real estate loans are typically not rated but are secured by mortgage over a specific real estate asset or assets. The security does not fall within the specific rules on collateral set out in the EU Solvency II Directive. Changes to the EU Solvency II rules in 2019 significantly mitigated this through the introduction of rules to allow insurers using the standard model to self-rate their investments in unrated bonds. Life insurers are also more likely in practice to use their own internal models for credit risk. The treatment of unrated bonds and anomalies that arise from the use of modified duration might be problematic for anyone using this, and we are not sure if any UK life insurance companies actually are in practice.

The more significant question for UK life insurance companies is the extent to which real estate debt falls within the matching adjustment.

Matching adjustment

We welcome the proposed expansion of the matching adjustment to include a wider range of real estate and infrastructure debt. As noted above, we believe that some long-lease real estate investments should be eligible to fall within an expanded matching adjustment. The consultation does not provide detail on proposed changes to the eligible assets for the matching adjustment; however, we believe that the various real estate industry trade bodies could contribute to the technical discussions on this matter.

Conclusion

Hopefully, the consultation will go beyond the specific issues mentioned and look holistically at the costs and benefits of the Solvency II regime generally. While we fully support Solvency II’s goals of providing adequate protection of policyholders and beneficiaries, and to ensure the financial stability and fair and stable markets, the role that Government policy can play in facilitating insurers’ financing of the real economy and green transition, along with levelling up the regions, is also extremely important.

The various real estate industry trade bodies that have contributed to this paper would be happy to participate in further technical discussions on this matter with HM Treasury and the PRA. We are also sharing this paper with the PRA.

IPF Investment Property Forum

Working Group Members

Alan Gardner – Tutor in Real Estate and Planning, University of Glasgow

Chris Thorne – Founding Director, Valuology

Jacqui Bungay - Policy Secretariat, Association of Real Estate Funds (AREF)

Jeff Rupp – Director of Public Affairs, European Association for Investors in Non-Listed Real Estate Vehicles (INREV)

John Forbes – Principal, John Forbes Consulting LLP, AREF Public Policy Committee & Indirect Property Funds Group Investment Property Forum (IPF)

Imran Razvi – Senior Policy Adviser, The Investment Association (IA)

Ion Fletcher – Director of Policy (Finance) British Property Federation (BPF)

Melville Rodrigues – Apex Group Head of Real Estate Advisory & AREF Public Policy Committee

Paul Richards – Managing Director, AREF

Robert Boag – Independent Consultant & AREF Investor Committee

Robert Warren - Senior Policy Adviser, Prudential Regulation, Association of British Insurers (ABI)

Sue Forster – Chief Executive, IPF

Acknowledgments

Association of Real Estate Funds (**AREF**), British Property Federation (**BPF**), and the Investment Property Forum (**IPF**) (together "the Associations") would like to acknowledge the support provided by the Working Group Members in drafting and settling this recommended response. This response would not have been possible without their support.

Disclaimers

This document is for information purposes only. The information is believed to be correct, but cannot be guaranteed, and the opinions expressed constitute the views of the Working Group Members in a personal capacity as of this date but are subject to change. The views do not necessarily represent the views of their organisations i.e. named above in relation to relevant Working Group Members.
Reliance should not be placed on the information and opinions set out in the document for the purposes of any particular transaction or advice.

The Associations and the Working Group Members do not accept liability arising from any use of this document.