INREV Response to European Commission Capital Markets Union Green Paper

On 13 May 2105, INREV submitted its response to the European Commission's Capital Markets Union Green Paper. The paper sought public comment and suggestions on how the European Union can stimulate economic growth and create jobs.

INREV welcomes this initiative, which seems to herald a new approach of policy makers in Brussels. It marks a clear shift in focus away from efforts to impose restrictions on the financial sector and increase regulatory oversight that has prevailed since the outbreak of the financial crisis. Efforts are now increasingly directed toward trying to ensure that the newly enacted financial regulations actually work while, at the same time, creating a climate that encourages institutional investors to support Europe's halting financial recovery.

The Capital Markets Union initiative is rooted in this new approach. Even though it is clearly focused on encouraging investment in infrastructure and access of small and medium enterprises (SMEs) to capital, it creates opportunities for INREV and allied real estate industry groups to remind policy makers that real estate investment plays a critical role in stimulating economic growth, fostering stability and creating jobs. At the same time, the Capital Markets Union initiative offers an opportunity to point out that some aspects of recently adopted regulations create impediments to the flow of institutional capital into this important economic sector.

Response regarding what further measures could help to increase access to funding and channelling of funds to those who need them (Green Paper Question 5)

Commercial Real Estate investment – the missing piece in the Commission's CMU vision

Despite the Green Paper's focus on stimulating European economic growth and creating jobs through encouraging investment in infrastructure and supporting SMEs, it doesn't mention a critically important sector: Commercial Real Estate investment.

The commercial property sector directly contributed EUR 302 billion to the European economy in 2013, the last year for which we have full-year figures, representing about 2.6% of the total European economy.[1] This is more than either the European automotive industry or the European telecommunications sector. The commercial real estate sector in Europe employs 3.8 million people, which is, again, not only more than either the automotive industry or the telecommunications sector, but also greater than banking.

Most activity in the commercial real estate sector is through the construction and repair of buildings. The upkeep, management and care of commercial real estate is also a sizeable activity, undertaken either directly by property owners or on their behalf by a growing number of specialist contractors, a

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[1] These and most of the figures cited in this section are from Paul Mitchell Real Estate Consultancy Ltd's *Real Estate in the Real Economy*, 30 May 2104.

significant percentage of which are SMEs. All of these activities are an essential part of maintaining and improving the quality of the accommodation services provided to businesses.

Commercial property, other than conventional residential rental housing, encompasses shops and retail outlets, offices, warehousing and logistics premises, as well as hotels, student housing, senior housing, leisure facilities and other forms of social infrastructure. New forms of commercial property are continuously emerging.

Commercial real estate plays a vital role in Europe's business, industry and social life. Its market value was approximately EUR 5¼ trillion in 2013 and is increasing as the economy and commercial real estate markets continue to recover from the global financial crisis. This amount is comparable to the value of the plant, machinery and equipment used in Europe's businesses and manufacturers.

Around 40% of all commercial property – with a total market value of over EUR 2 trillion – is held as an investment.

Many businesses prefer the flexibility of renting and choose not to commit the capital and management time required by owner-occupation. The ability to lease rather than own premises offers flexibility to businesses, including start-ups and SMEs. Around 40% of all European commercial property is rented office space, allowing companies to channel more of their scarce capital into growing their businesses. The commercial real estate industry meets this need by investing in commercial property and providing accommodation services to these businesses.

Listed property companies and Real Estate Investment Trusts (REITs), along with non-listed real estate funds and other collective investment vehicles, are widely used by insurance companies and pension funds to invest in real estate. Together, they are the biggest single owners of commercial real estate, while insurance companies and pension funds' directly owned share of commercial real estate, while considerable, has been declining in recent years.

Investment, however, is becoming more global. The amount of commercial property in Europe held by non-EU institutions, including Sovereign Wealth Funds, is estimated to be EUR 111 billion at the end of 2013, and this figure is increasing.

Rental housing represents a small but growing proportion of institutional investors' real estate holdings. The amount is estimated to have grown to EUR 127 billion in 2013, a rise of 27% since 2011; houses and apartments now represent 11% of institutional investors' portfolios. While growing, this is still tiny by comparison to the total value of owner-occupied housing in the EU of approximately EUR 24 trillion and in comparison to the amount which is privately owned and rented out by non-institutional investors.

CRE and infrastructure

Commercial Real Estate (CRE) and infrastructure together form an integral part of our urban environment and to a significant extent they are highly interconnected. Real estate development and re-development are generally only possible when they can be connected with good transport, energy and communication infrastructure. At the same time, providing or extending such infrastructure only makes sense where it connects with buildings and the built environment where people live, work, shop and enjoy leisure activities.

It's difficult to draw a clear line between real estate and infrastructure investment, particularly when it comes to social infrastructure such as healthcare, educational and leisure facilities. While in many European countries such facilities may historically have been provided by the state, institutional investors are increasingly looking to invest in such projects. In addition, real estate developers and owners are often responsible for the urban infrastructure immediately surrounding their projects, such as green spaces, transport links and public information amenities. This further emphasises the connection between real estate and infrastructure.

An important source of income for European savers and pensioners

Commercial real estate can serve as a long-term investment for institutional investors. The long-term cash flows generated from commercial real estate rent streams provide an important source of diversified income in the portfolios of European savers and pensioners. Property in its various forms accounts for EUR 730 billion of European pension funds' and insurance companies' investments. This represents an average allocation of nearly 6%.

Direct ownership and exposure through non-listed funds are now of comparable magnitude. Overall, indirect investment – either through non-listed funds and other vehicles or through listed property companies and REITs– is becoming increasingly important.

Pension funds' and insurance companies' exposures to commercial real estate is effectively higher than EUR 730 billion because property companies, REITs and unlisted real estate collective investment vehicles, like private households, often use debt to enable them to boost the amount of property they hold. Including debt taken out that is generally secured by the property, European pension funds' and insurance companies' beneficial interest in commercial and residential property is closer to EUR 1 trillion.

Distortive effects of recently enacted regulations

In making new laws and regulations, the important role that the real estate industry plays in the economy and society should be recognised. However, we believe that this has not been the case, particularly in relation to Solvency II. Under this regime's standard model, insurers' direct investments in commercial real estate and investments through non-listed funds attract a 25% risk weighting.

This 25% estimate of the volatility of European commercial real estate investments was set by reference to data from the EU's most volatile real estate market, the UK, due to a lack of availability of historical real estate data at the time the directive's solvency capital charges were being developed. A subsequent review of Solvency II by independent research organisation IPD (the same company that produced the index used to calculate UK real estate market volatility) using data representative of wider European property market volatility clearly demonstrates that it would be unreasonable to impose a capital solvency charge of more than 15%.[2]

The 25% standard solvency capital charge for real estate is seen by some policy makers as an insignificant issue, as insurers have the option of developing an internal model that is tailored to reflect

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[2] *The IPD Solvency II Review, Informing a new regulatory framework for real estate*, 15 April 2011, updated 21 July 2011.

the real volatility of their own real estate portfolios and therefore a lower solvency capital charge. However, internal models are not as viable an alternative as many assume; they are very expensive to develop and are very time and energy consuming. As a result, they will only be an option – at very high cost – to very large insurers that can shoulder such costs, which puts smaller insurers at a competitive disadvantage to the larger ones. For that reason as well, Solvency II is market distortive.

While much attention is being given to developing a solvency capital charge for infrastructure under Solvency II that does not create disincentives to invest in it, very little attention seems to be paid to the need to re-calculate the solvency capital charges for real estate based on the appropriate data. However, this is a step that is badly needed.

Solvency II's treatment of lending against commercial real estate is similarly inappropriate, as it does not allow insurers to take account of the collateral or security value of the asset being funded. This results in insurers having to set aside a disproportionately high amount of capital given the likely risk of loss. Similarly, CMBS receives punitive treatment under Solvency II.

Finally, the requirement under Solvency II that the value of long-term assets such as real estate be 'marked to market' on a regular basis for reporting and solvency capital charge calculation purposes is not conducive to supporting long-term investment. Assets held for the long term in order to capture their long-term income streams are not generally used to meet insurers' liquidity needs, yet are treated as if they were under Solvency II. Ironically, the marked to market approach has the opposite effect and actually leads to creating incentives for short-term investment in real estate, which is counter-cyclical and increases systemic volatility.

A regulatory system that wrongly calibrates the risks of investing in particular types of asset is not only distortive, but is also unlikely to deliver the best outcome in terms of capital allocation. By making real estate unnecessarily expensive in capital terms, Solvency II erects barriers to investment in the EU's built environment and makes it more difficult for institutional investors to channel money toward the provision of social and urban infrastructure. There seems to be very little appreciation of the detrimental impact that a flawed regulatory framework can have on the wider economy. We encourage the Commission to review the capital requirements of Solvency II with a view to removing obstacles to appropriately weighted capital flows into real estate.

Contributing toward a low carbon economy

Buildings contribute significantly to energy use and greenhouse gas emissions, although the latest data do show a modest decline. Directly and indirectly, buildings (excluding factories) now account for just under 40% of the EU's energy consumption and about 30% of its emissions. Residential housing accounts for the vast majority of this, with non-residential buildings – including the public sector – accounting for 12% of the EU's energy consumption and greenhouse gas emissions.

Residential and, to a lesser extent, commercial and public sector buildings also represent one of the most important untapped potential sources of energy savings. The cost over the decade of meeting this untapped potential for residential and non-residential buildings has been estimated at almost EUR 60 billion per year – a big commitment which emphasises the importance of Europe's commercial property sector in delivering these important energy efficiency improvements.

Commercial Real Estate (CRE) makes an essential contribution to the economy by enhancing productivity through the varied and flexible provision of accommodation for businesses and people and their changing needs. It also plays a leading role in tackling climate change, supporting the digital economy and increasing accessibility by encouraging and adopting technical innovation in building design and the retrofitting of existing buildings. And finally, office buildings and shops are essentially the urban infrastructure without which we would have no towns or cities. But buildings need continuous re-investment to remain fit for purpose in a rapidly changing world. To keep our urban environments vital, liveable, accessible and attractive, and to develop smart cities, real estate investment needs to occur free from unnecessarily burdensome and market distortive regulations and real estate investment should be given greater consideration in EU policymaking.

Response regarding what policy measures could incentivise institutional investors to raise and invest larger amounts and in a broader range of assets, in particular long-term projects, SMEs and innovative and high growth start-ups (Question 10)

The best way to create incentives for investors, including institutional investors, is to ensure that regulation both promotes transparency and avoids distorting economic risks and returns. Unfortunately, certain elements of post-crisis EU regulation have gone too far in seeking to create disincentives to particular investments. An example would be the way the capital framework under Solvency II imposes a substantially higher charge for holding the most senior tranche of a bond backed by securitised CRE debt (if it has a duration of three years or more) than the charge it imposes for owning the commercial building on which the CRE debt is secured.

Investment in infrastructure

As noted in our response to question 5, the line between infrastructure and real estate is very hard to draw in a sensible way and, in any case, the two asset classes work together hand-in-glove in the built environment. Both are intrinsically long-term real assets whose development takes considerable planning and effort and therefore deserve a supportive and stable regulatory environment. That is not currently the case for real estate investment, particularly for insurers under Solvency II, as mentioned in our response to question 5. As it stands, this regulation discourages investment in our built environment, including in the long-term, transformative projects that most benefit our towns and cities while stimulating the real economy and driving the creation jobs.

It is widely accepted that Europe requires significant infrastructure investment in order to maintain its competitiveness. There has been significant debate over the past few years as to how additional capital can be encouraged to invest in infrastructure and we support that goal. Greater transparency and clarity regarding infrastructure project pipelines could be extremely useful for attracting institutional capital. In addition, a co-ordinated, coherent view of the role of, and need for, related real estate investment when planning infrastructure projects would also be welcome.

Response regarding what steps could be taken to reduce the costs to fund managers of setting up and marketing funds across the EU, and what barriers there are to funds benefiting from economies of scale (Question 11)

The Green Paper correctly identifies differences in Member State approaches to fund and fund manager authorisation as barriers to greater cross-border fundraising. Another barrier is the differing approaches that Member States take to what constitutes 'marketing' a fund under both AIFMD and private placement regimes and whether permission is required to carry out such activities. Uncertainty and inconsistency in this area discourage fundraising by making it more expensive.

However, perhaps the greatest concern for prospective fundraisers is the AIFM Directive itself. While it provides for the first time a (broadly) single set of rules for fund managers across the EU, it also introduces demanding and costly compliance requirements. Concerns arise about industry consolidation as fund managers merge or close funds as the costs of compliance for individual products become too heavy to bear, especially as the benefits of passporting appear largely not to have materialised.

Perhaps more worryingly, the AIFMD introduces substantial fixed costs for fund managers that disproportionately affect smaller firms. The requirements of the Directive have become a barrier to entry, entrenching the position of the largest firms that are able to afford well-staffed compliance departments while stifling innovation by and competition from new challengers. While any new regulation is likely to have teething issues, we would encourage the Commission to keep a close eye on developments in the fund management world to assess whether the AIFMD has led to any consolidation or reduction in competition in the sector.

Response regarding which measures the European Commission should prioritise in future reviews of the prudential rules such as CRDIV/CRR and Solvency II (Question 12)

As mentioned in our response to question 5, real estate investment, side-by-side with infrastructure, plays a critical role in delivering the urban environment that makes cities vital, desirable places to live and work. We urge that any review of solvency capital charges for infrastructure under Solvency II be conducted alongside a review of solvency capital charges for real estate in order for both asset classes to better fulfil their potential to stimulate European economic growth and job creation, while supporting SME and helping achieve Europe's sustainability goals.

Response regarding what support can be given to ELTIFs to encourage their take up (Question 3)

Additional guidance concerning the ELTIF requirement that, to be ELTIF-eligible investments, residential and commercial real estate must be integral to or an ancillary element of a long-term investment project that contributes to smart, sustainable and inclusive growth in Europe or the EU's energy, regional and cohesion policies would be helpful.

The wording of the requirement is too vague for potential investors and fund managers to determine what real estate investments would be eligible, which does not encourage take-up of ELTIFs. In addition, the more broadly these investment eligibility requirements are interpreted, the more likely it will be that ELTIFs will be attractive to investors.

Response regarding whether there are additional actions in the field of financial services regulation that could be taken to ensure that the EU is internationally competitive and an attractive place in which to invest (Question 21)

Review of the complexity and cumulative effect of financial regulation

Over the past five years, financial services regulation has become increasingly complex and prescriptive, with rulebooks running to thousands of pages that most businesses and regulators currently struggle to really understand. Familiarity with the new regulatory landscape should increase over time, but the sheer scale of the legislation that now applies to the financial sector means that nobody can be expected to fully comprehend how it all fits together.

This lack of high level oversight poses a significant risk. Post-crisis regulatory initiatives were largely developed in silos, each with a particular objective, and the impact of each was assessed on a stand-alone basis. There has been little consideration of the cumulative impact of financial sector regulations such as AIFMD, EMIR, Solvency II, CRD IV on critical economic sectors and their subsequent impact on European economic stability, growth and job creation. This message emerged strongly in responses to a consultation of the Economic Affairs Committee of the European Parliament on enhancing the coherence of EU financial services legislation.

We would also support a number of the other themes that emerged during that consultation, in particular the need for more realistic timeframes for developing regulation (taking into account the time needed to prepare Level 2 measures). We would also encourage greater harmonisation, or at least recognition of equivalence, between different regulatory regimes around the world - especially between the EU and the US.

The gold-plating by Member States of various regulations that were developed to create a single rulebook for Europe is also a problem and undermines the goal of such regulations. AIFMD and Solvency II are examples and the different national requirements and interpretations not only add complexity, cost and uncertainty, they also have the effect of discouraging cross-border capital flows.

The combination of very broad brush high level policymaking and very complex detailed regulation developed in silos and subsequently gold-plated by national regulators has meant that a critically important industry sector like commercial real estate can be overlooked and side-lined, to the detriment both of the industry and of the economy and financial stability.

Response regarding what measures can be taken to facilitate the access of EU firms to investors and capital markets in third countries (Question 22)

Greater harmonisation or equivalence of financial regulation with third countries would assist with achieving this goal, along with insistence on generally reciprocal access for European investors in those countries whose investors and managers are granted access to the EU, which for example is being considered pursuant to AIFMD.

Response regarding what specific aspects of insolvency laws would need to be harmonised in order to support the emergence of a pan-European capital market (Question 29)

The very different insolvency and enforcement regimes facing lenders across the EU can present real challenges, limiting the effectiveness of the single market in the financial sector. Lenders often have to accept significant structuring costs or legal uncertainty when they seek to minimise the constraints imposed on them by slow, cumbersome or simply borrower-friendly regimes in particular, mostly southern European, countries.

That, and the fact that some countries only allow commercial real estate lending by entities holding a banking licence in their jurisdiction, are the two major impediments to the emergence of a pan-European loan capital market that could support commercial real estate investment. It is worth noting that some of the countries worst affected by those impediments are also facing the biggest challenges with their domestic banking systems. Italy and Greece are examples.

Response regarding what barriers there are around taxation that should be looked at as a matter of priority to contribute to more integrated capital markets within the EU and a more robust funding structure at company level and through which instruments (Question 30)

The OECD is currently reviewing the international system of taxation to identify how aggressive cross-border tax avoidance can be curtailed. While the intention behind these efforts is laudable, some of the proposals tabled by the OECD have the potential to considerably disrupt international investment.

We would urge the Commission actively engage in the development of the OECD proposals and critically challenge them where they might pose a risk to multinational trade and investment. We set out two particular concerns below.

Double tax treaties

In order to encourage greater flows of capital across Member States it is very important that cross border investment is not penalised through the tax system. This is particularly true for collective investment undertakings (CIUs), where the aim should be for ultimate investors to suffer no more tax than if they had invested in the underlying assets directly while at the same time benefitting from the economies of scale and professional management provided by collective investment. In this context, the ability to access double tax treaties (DTTs) is crucial as otherwise an investment may suffer multiple layers of taxation, rendering it economically unviable.

Action 6 of the OECD's BEPS plan is to review whether access to DTTs should be restricted in order to prevent them being used to egregiously avoid tax. We support this goal, but the proposals currently on the table could result in CIUs not being able to claim the benefits of DTTs. The way that the ‘limitation on benefits’ and ‘derivative benefits’ clauses are currently drafted is particularly problematic, as they would deny relief to ‘alternative’ investment funds (e.g. real estate, private equity) and entities within their investment structure.

If these proposals are not changed before being implemented, the negative impact on cross-border investment through CIUs could be enormous. The commercial viability of multinational real estate and private equity investment structures would be jeopardised and the valuable contribution they make to both the real economy and to savers severely curtailed.

Tax treatment of debt vs. equity

Numerous commentators have suggested that the relative tax treatments of debt and equity could create distortions or perverse incentives in the way that businesses finance themselves. According to the OECD (Action 4 of the BEPS plan) it also gives rise to opportunities for profit shifting, and there appears to be an emerging view that the tax deductibility of debt finance should be generally restricted.

We suspect that too much prominence is being attributed to the deductibility of debt finance as a reason for its widespread use. In a real estate context, and probably across other sectors of the economy, there are powerful commercial reasons for using debt finance, including:

- Debt is vital to equity constrained investors. Debt finance opens up investment opportunities that would otherwise not be possible, and this helps to drive economic growth.
- Debt allows for greater risk diversification. Borrowing money means you can afford to commit less equity to individual assets and can gain investment exposure to a greater range of assets. This reduces the vulnerability of portfolios and helps to smooth overall returns.
- Debt can be more flexible than equity. Borrowing arrangements can also be tailored to reflect individual circumstances and can be periodically renegotiated. The greater accessibility and flexibility of debt allows funding to be provided to investment opportunities more quickly which ultimately facilitates quicker economic growth.
- Debt can facilitate the repatriation of income to investors. Many countries impose restrictions on the amount of equity capital that can be returned to investors in a particular time period. Intra-group lending arrangements make it easier to provide returns to investors, who may require these on a regular basis in order to meet their own liabilities as they arise.

Restricting the tax deductibility of debt finance is therefore unlikely of itself to push businesses towards a greater reliance on equity, although it may make a difference at the margins. Neither would it necessarily encourage more equity issuance in the EU. A recent Bank of England paper on capital markets union[3] points out that *"the available data suggesting that the US – which has by far the largest quoted stock markets in the world in absolute terms – has one of the highest effective average corporate tax rates to debt on equity-finance new corporate investment."* In other words, the tax treatment of debt in the US is particularly favourable as compared with the treatment of equity, but nevertheless businesses make relatively greater use of equity finance than they do in the EU.

Restricting the deductibility of debt would pose an enormous transitional challenge for all businesses and over the longer term would disadvantage those industries that – by virtue of being inherently

[3] *A European Capital Market Union: implications for growth and stability*

capital intensive – are structurally reliant to a greater extent on debt finance, such as infrastructure and real estate. Accordingly, any proposals to change the tax treatment of debt finance need to be carefully thought out, the reasons for effecting the changes must be clear and it must be reasonably certain that the desired outcome could not be achieved through other means. Although the OECD technically only makes recommendations that individual countries are free to adopt or not, its influence is enormous and a recommendation that does not meet these standards should be avoided.