Real Estate Investment Under Solvency II

- > Real estate SCR currently 25%
- > Review mandated by end of 2018
- > Research supports SCR ≤15%

Main Objective

The Solvency II Directive was designed to create a single market for insurance services in Europe and to harmonise the capital adequacy requirements of European insurance providers. Solvency II seeks to guarantee that insurers can meet their obligations to policyholders with 99.5% probability, even in case of extreme market downturns. This goal is to be achieved in part through a capital reserve requirement applicable to insurance providers' various investment asset classes, dependent on their assumed risk profiles.

Background

Insurers have the option to develop internal risk models that reflect the risks inherent in their own portfolios, which must be approved by relevant national regulators. In the absence of an approved internal model, however, the standard model's capital reserve charge applies. Under the directive, the standard Solvency Capital Requirement (SCR) is 25% for real estate. In contrast, the standard SCR is 49% for private equity, 39% for listed equities, 30% for qualifying infrastructure investments and zero for all EU government bonds. The capital requirement for debt, including real estate debt, depends on its rating and duration.

Following the look-through approach, investments in non-listed real estate vehicles, including funds, by insurers applying the standard model are subject to the 25% standard capital reserve charge applied to the fund's GAV with an additional charge applied to leverage.

Key Issues

Calculation of SCR for real estate investments

The standard SCR for real estate is based exclusively on data from the UK commercial property market, which is more volatile than most other European property markets. Furthermore, the data heavily reflect the relatively volatile London retail and office market but exclude the relatively more stable UK residential real estate investment sector.

The proposed 25% standard SCR applicable to real estate is therefore significantly higher than data reflecting the entire European property market support. In 2011, while the Solvency II directive was still being developed, research carried out by IPD concluded that a standard SCR of no more than 15% would more accurately reflect the risk of European real estate markets.

Despite industry efforts to urge policy makers to adopt a 15% standard SCR for real estate that more accurately reflects the risk, in late 2013 European regulators adopted the Solvency II directive with the 25% standard SCR for real estate investments. This requirement forces insurers to sideline excessive amounts of capital, which arguably distorts rational investment decision making for real estate.

Review of Standard Model Solvency Capital Charges

A review of the SCRs by December 2018 was mandated in the Solvency II directive. In March 2017, to prepare for this review and provide fresh evidence to support an SCR for real estate that more accurately reflects the volatility of real estate investment in Europe, IPD-MSCI published an update of the 2011 study. The update adds five countries and six

> 'INREV is encouraging policy makers to adopt an SCR for real estate that more accurately reflects the documented risk'

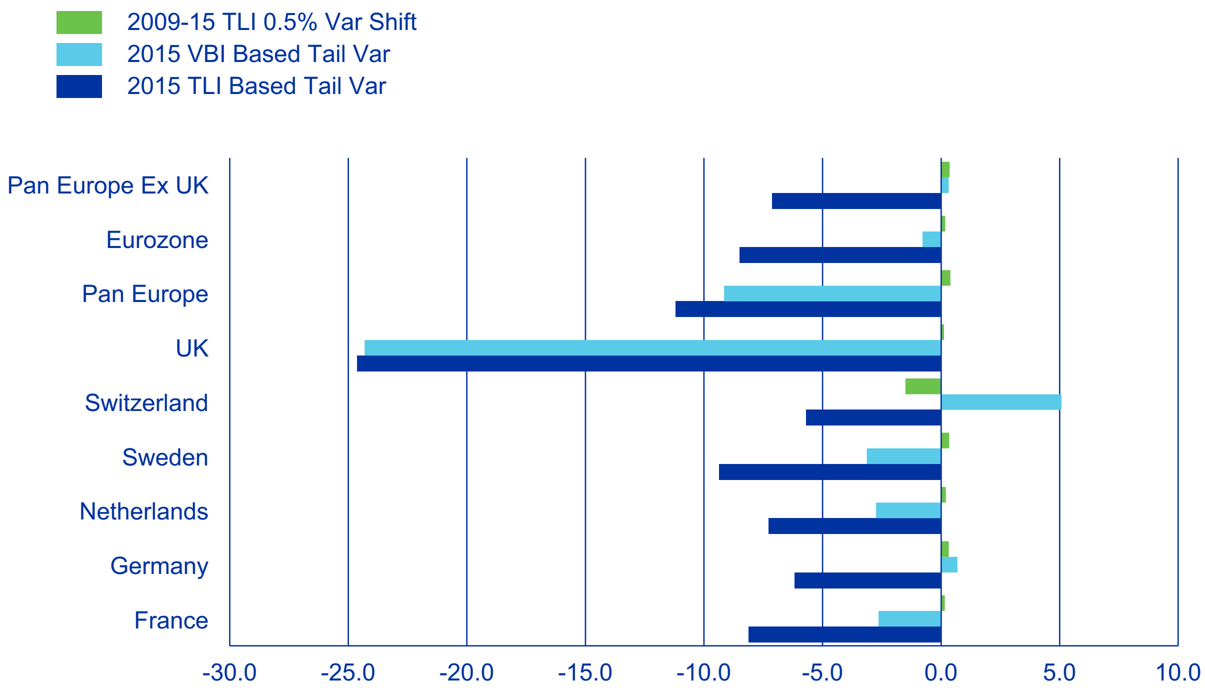
years of European investment market data to that available for the original study, bringing the capital risk analysis up to December 2015.

The IPD-MSCI update adopted a three-step approach, which involved:

1. constructing full 15-year quarterly valuation based indexes (VBI) for each of the 17 European markets fully covered by MSCI;
2. estimating any additional trading volatility using transaction linked indicator (TLI) methods for key national markets and all relevant pan-European composites; and
3. utilising these new series to establish better grounded "value at risk" estimates, using EIOPA defined methodologies to identify worst case 12-month negative return sequences.

This comprehensive scan for the most extreme current evidence of European tail values at risk indicates that any downside disruptions since 2009 have not been of a scale to merit revising the core 2011 conclusions. The appropriate shock factors to use for determining real estate solvency capital requirements therefore would not exceed 15% for all Europe, or 12% for European composites that exclude the UK.

Outside the UK, risks of extreme shocks show even less need for high charges (2015 vs 2009 results)



Based on TLI and VBI-driven 12-month 0.5% total return tail values at risk

Source: MSCI Real Estate Solvency II 2017 Update Report

Advocating for a more representative real estate market shock factor

The Solvency II standard model SCR for real estate has been raised in meetings with policy makers in the European Parliament, Commission and Council, as well as EIOPA. It has also been addressed in all INREV's relevant regulatory consultation responses, including the Capital Markets Union, which is focused on removing obstacles created by EU financial regulations and increasing long-term investment in Europe. INREV is actively taking steps to ensure that policy makers include the results of the 2017 update in their review of Solvency II that must be completed by December 2018.