

Response to EIOPA consultation paper on the Opinion on the 2020 Review of Solvency II



09 January 2020

Q5.1: Do you know data sources which would help to better calibrate property risk?

The availability of data that can be used to measure the volatility of real estate in all property markets in the EU over a very long time is a fundamental challenge. As the consultation paper noted, “the main specificities of real estate as an asset class are its illiquidity (infrequent and irregular trading, no central market place where prices can be easily observed) and its heterogeneity (in terms of characteristics influencing the value of the asset – e.g. location, size and other physical characteristics of the building).”

While many of INREV’s life insurer members that developed internal models indicated to us that they were able to use a variety of data sources that match the specificities of their own portfolio composition, a single data source that perfectly measures volatility of real estate across all EU markets over a very long time series, sufficient to definitely establish the downside tail risk of a one-in-two-hundred-year event, does not exist. However, there is indisputably much better data available now than there was when the initial calibration for real estate was adopted. At the time, the UK was deemed to be the only source of deep and sufficiently frequent data and the IPD monthly UK Index, comprised primarily of London office and retail properties, was used.

As the consultation paper correctly points out, the value of real estate assets can only be observed on two occasions: when valuations are performed and when property is sold. It is also correct that value stemming from actual transactions are too infrequent to form the basis of reliable indices. Real estate is typically a very long-term investment that institutional investors such as life insurers use to meet their long-term liabilities (we note in this regard that the 16 December 2019 EIOPA ‘Report on insurers’ asset and liability management in relation to the illiquidity of their liabilities’ showed that insurers hold property-related investments for 14 years on average, the longest of any asset class discussed, p.69). In addition, the high transaction costs incurred in buying and selling real estate make it highly unattractive as a short-term investment. Furthermore, as long-term investors, they do not normally sell their real estate investments during downturns in the market; they hold them and ride out the downturn while the real estate investments continue to deliver relatively stable income returns, which accounts for the lack of real estate transaction data in economic crises. It is important to note, however, that a lack of real estate transaction data does not support a conclusion of high volatility.

Valuation data, although subject to some smoothing, lagging and subjectivity, are available from much more reliable sources than tax assessments mentioned in paragraph 5.82. Tax assessments are indeed an unreliable basis for measuring value across all European property markets. In contrast, the valuations performed for institutional investors and fund managers are much more standardised and professional, which is understandable considering that the infrequent trading makes institutional investors keen to closely monitor the value of their investment portfolios through professionally conducted independent third-party valuations applying industry-wide standards. In almost all EU countries, valuers are trained and certified, for example by RICS, and follow valuation guidelines consistent with the International Valuation Standards Council (IVSC) standards. The wide application of these standards across Europe by trained, professional valuers makes missing physical characteristics of any property highly unlikely. These factors also provide much more consistency and, as a result, reliability, than the consultation paper suggests.

Valuations performed for institutional investors such as pension funds and insurance companies are the basis of all the direct real estate indexes computed and published by MSCI. They also constitute the baseline market reference points for its Transaction Linked Indexes (TLIs). However, the central purpose of the TLIs is to identify the additional impacts of actual trading activity, specifically upon the measurable volatility of intrinsically lumpy, heterogeneous and illiquid real estate investment markets. This is achieved by regressing all achieved sale prices in each period upon the preceding valuations of the sold assets so that the potential risks of transacting in complex real estate markets are fully and consistently identified.

The consultation paper reflects the time and effort that EIOPA have invested in understanding the data challenges related to measuring real estate volatility. The paper notes that, as with every regression, the robustness of the estimated parameters depends on the number of underlying transactions in each bucket and that, for some markets, they are scarce. Accepting that there are fewer transactions in many markets than would ideally have taken place to support a highly robust transaction linked index, the MSCI TLI discussed in the EIOPA consultation paper (from the publicly available MSCI Real Estate Solvency II 2017 Update Report - see link [here](#)) gives a much better picture of volatility across the EU than making the unwarranted assumption that data from the UK alone, and then primarily the highly volatile London office and retail property market which completely exclude the residential market, are representative of the entire EU commercial property investment market.

The MSCI TLI is based on a three-step approach, first based on a full 15-year quarterly valuation based indexes for each of the 17 European markets it covers, then estimating any additional trading volatility using TLI methods for key national markets and all relevant pan-European composites, then using these new series to establish better grounded value at risk estimates using EIOPA defined methodologies to identify worst case 12-month negative return sequences.

Among the three actual policy options based on data made available to EIOPA that are indicated in the consultation paper, option one of maintaining the status quo is simply not acceptable. First, the UK commercial property market is not representative of the entire EU commercial property investment market. Second, more and better data and analysis are now available. And third, as noted, the current measure of property volatility based on UK data only does not recognise how diversification of insurers' portfolios by geography and sectors lowers the volatility of their real estate portfolios. Insurers typically diversify their real estate investments in order to spread risk and therefore lower volatility while generating the returns needed to meet their obligations to policy holders.

The growth of non-listed real estate funds in Europe can, in fact, be attributed to a great degree to institutional investors such as life insurers seeking diversification outside their domestic markets. Even relatively small institutional investors can and do pool capital and therefore gain access to investments that lower their risk-adjusted returns, sourced and managed by managers with local knowledge and access to deal flow. There is some irony in the reference in paragraph 5.96 to small insurers often holding property only in their own country, because in a chicken-and-egg situation, many experts see the current excessively high standard model SCR for real estate and associated return drag as creating a disincentive to those insurers making such investments, even though they could help lower their real estate portfolio volatility and concentration risk.

Between the actual policy options discussed in the consultation paper of calibrating a single common shock with data from more countries than just the UK (option two) and creating two different shocks, one for some countries and another for the rest (option three), INREV strongly supports option two and a single common shock. Option three would depart from the Solvency II pan-European approach that has been used to date for all standard formula modules and sub-modules and would likely exacerbate

the distortive effect of property SCRs by creating winner and loser commercial property investment markets for insurers.

A further question arises, however; how would the UK property market be treated once it falls outside the EU? Should data from the UK even be considered in the volatility analysis given that UK insurers will likely fall outside the direct scope of Solvency II? Therefore, should UK insurers' heavily domestic property portfolios be included in the EU property investment market weightings? And given the fact that insurers in the remaining-27 EU Member States invest in UK property at much lower levels than UK insurers do, should the 27% market weighting of the UK be lowered? This would indisputably lead to a lower measure of the volatility of property investments in Europe.

In fact, MSCI's comprehensive scan for the most extreme current evidence of European tail values at risk indicates that the most appropriate shock factors to use for determining real estate SCRs would not exceed 15% for all of Europe if the UK is fully included, or 12% for European composites that exclude the UK. We strongly urge EIOPA to consider these findings and the data underlying them in recommending a common single shock for standard model users across the EU.

Q5.2: For Internal Model users please indicate the approach chosen to model property risk within your Internal Model, when applicable.

A number of our insurer members provided us with information regarding the approach they used to model property risk in their internal models. Almost all indicated that they use a combination of TLI series and VBI series or some other city/sector specific assessment of value at risk, while one used risk factors to estimate the underlying systemic risk. The data underlying the TLI and VBI series came from a variety of sources and were generally supplemented by other data sources where appropriate to provide additional sector or geographic insights into historical volatility of their specific real estate portfolios. No series potentially broadly representative of property markets in Europe and very few narrower series extended significantly further back in time than the MSCI TLI from the MSCI Real Estate Solvency II 2017 Update Report (see link [here](#)).

