Response to European Commission Solvency II Review Roadmap

25 August 2020

INREV* is pleased to have the opportunity to make a few brief comments on the Inception Impact Assessment 'Roadmap'.

INREV strongly supports the Commission's decision to undertake a broad scope of review that goes beyond the required Solvency II review topics. While we fully support Solvency II's goals of providing adequate protection of policyholders and beneficiaries, and to ensure the financial stability of the Union and fair and stable markets, the role that European Commission policy can play in facilitating insurers' financing of the real economy is also extremely important. As we have frequently argued, the current Solvency II prudential rules hinder insurers' ability to contribute to the long-term funding of the economy in the EU, which is now an especially important point as the EU tries to recover from the economic impact of the Covid-19 outbreak and simultaneously address urgent climate change challenges.

Long-term investment[1]

Long-term investment is critically important to the European economy and society. Life insurers, like other institutional investors such as pension funds, are the source of much of the long-term investment in Europe as they seek out investments that deliver long-term, stable income streams and thereby enable them to meet their long-term liabilities to policyholders.

Real estate makes up an important part of the investment portfolios of almost all life insurers. Real estate investment, whether made directly by purchasing buildings or indirectly by investing collectively through real estate funds, helps insurers meet their obligations while, at the same time, makes a vital contribution to the wider economy, society and the environment.

Long-term real estate investment strategies are distinguished from shorter-term strategies by the underlying investment intentions and by the reliability of income returns. Holding periods are an identifying characteristic and it is noteworthy that insurers have identified real estate holding periods as the longest of all asset classes.

Life insurance companies are attracted to real estate's diversification benefits, its income generating qualities and its relatively attractive risk return profile. Their long-term real estate holdings are concentrated in low-risk core assets, which account for over 89.6% of their real estate investments by value. These assets offer longer-term, steady and often inflation-hedged income streams that can be used in the overall liability matching.

A review by EIOPA of insurers' average holding periods for the assets identified as long-term holdings are considerably higher than for the total portfolio, with real estate (including funds) having the longest average holding period of 14 years[2], which is even longer than infrastructure.

Importantly, real estate does not function as a liquidity buffer within life insurers' portfolios and is held through periods of stress; it is held for its diversification benefits and the income it generates by way of

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[1] A full report on this topic that contains many of the points raised in this submission can be found at: https://www.inrev.org/system/files/2020-04/INREV-Long-term-investment-for-Europes-future-2020-Report.pdf
[2] See: https://www.eiopa.europa.eu/content/insurers-asset-and-liability-management-relation-illiquidity-their-liabilities_en

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rental cashflows. Life insurers' real estate investments are focused on acquiring a long-term, certain income stream and sustaining capital value, rather than capital appreciation. The asset class can also offer valuable diversification benefits in a portfolio due to its lower correlation with other financial assets. Insurers typically invest in real estate across different sectors and geographies, which offers further diversification within the real estate allocation itself, a point that has been consistently underappreciated in the Solvency II regulation. Core real estate investing focuses on stabilised income streams which are often structured to offer strong inflation hedging characteristics, with contracted income commonly linked to CPI or a similar pricing index. This is especially beneficial for matching investment assets to insurers' future liabilities to policyholders.

Unlike owner-occupied housing, institutional real estate is acquired as a financial asset, not as a consumer good or personal utility. The institutional real estate market comprises assets that are of institutional quality and held in third party ownership. This invested market is made up of commercial real estate in Europe's major cities, including offices, retail and industrial/logistics premises. In addition, residential is an important sector, represented by portfolios of professionally managed private rented sector (PRS) multi-family assets as well as social housing portfolios.

The rationale for undertaking long-term investing is that it can provide superior returns through exploiting liquidity and/or market risk premia. As long-term investors, insurers have the capacity to invest counter-cyclically, thereby amplifying this enhanced return. Such long-term counter-cyclical strategies provide a floor for real estate markets during downturns as well as for the real economy and economic value growth. Importantly for addressing the current Covid-19 triggered economic challenges, the counter-cyclical nature of long-term investing greatly assists the stabilisation of financial markets during downturns.

While many of these points regarding the benefits of long-term investment have been tacitly acknowledged in the preferential treatment accorded to both infrastructure and long-term equities in order to remove barriers to insurers investing in the real economy in follow-on amendments to Solvency II, how they also apply to insurers' investment in real estate should be actively considered in the Commission's current review.

Real estate and Infrastructure

In recent years, life insurers have increasingly looked beyond traditional core retail, office and industrial buildings to invest in 'social infrastructure' projects such as affordable housing, student accommodation, leisure and sports facilities, healthcare facilities and care homes for the elderly. Because they can deliver stable, long-term income in the same way as traditional commercial property, they increasingly attract long-term capital to meet long-term liabilities, although they are subject to real estate solvency capital requirements.

Infrastructure and real estate investments are often mutually dependent, with one not being possible without the other. For instance, real estate assets, as social infrastructure, may not be sustainable in certain areas unless appropriate transport and utilities infrastructure is put in place – while those infrastructure enhancements are unlikely to be financially viable in the absence of substantial investment in the built environment.

Given their similarities as long-term asset classes, mutual dependencies and increasing overlap between different types of infrastructure and commercial real estate investment, both should be seen in view of their vitally important contribution to strengthening European economy, growth and job creation and the contribution they make to insurers' long-term investment portfolios.

ESG

Ensuring that the Solvency II framework also provides appropriate incentives to address climate and environmental risks and opportunities in insurers' investment policies is another important area of consideration in the holistic review of Solvency II. Together with other long-term institutional investors, life insurers have spearheaded the UNEP initiative to move towards a more sustainable future over the past fifteen years. The demands of such investors have transformed the built environment and will greatly assist in delivering on the commitments made in the Paris Agreement.

Creating a sustainable future for Europe's urban ecosystems requires a viable economy to be equitable and accessible to the society it serves, and for both to have a positive impact on the environment, in turn improving well-being, society and the economy. Real estate, in tandem with infrastructure, is the scaffold for delivering a sustainable future. These benefits are natural externalities of long-term investment.

Furthermore, like infrastructure, real estate is a source of employment that reaches far beyond its construction phase, which combined with the physical assets represents a long-term investment in viable and sustainable communities throughout Europe.

Conclusion

While INREV has previously addressed issues related to the standard model solvency capital requirements for real estate with EIOPA and the Commission and will comment further in the Commission's public consultation on the review of prudential rules, we applaud the Commission's decision to undertake a broad scope of review that includes considerations regarding incentivising long-term investment and ESG measures and look forward to contributing constructively on these important issues.

* INREV is the European Association for Investors in Non-Listed Real Estate Vehicles. We provide guidance, research and information related to the development and harmonisation of professional standards, reporting guidelines and corporate governance within the non-listed property funds industry across Europe.

INREV currently has 458 members. Our member base includes institutional investors from around the globe including pension funds, insurance companies and sovereign wealth funds, as well as investment banks, fund managers, fund of funds managers and advisors representing all facets of investing into non-listed real estate vehicles in the UK and the rest of Europe. Our fund manager members manage more than 500 non-listed real estate investment funds, as well as joint ventures, club deals and separate accounts for institutional investors.