Response to HM Treasury Review of Solvency II

18 July 2022

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, including the UK.

INREV currently has approximately 490 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.

Statement of position

Along with much or all of the institutional real estate investment industry, INREV 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.

Treatment of Long-Term investments under Solvency II

The EU Solvency II Directive that 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.

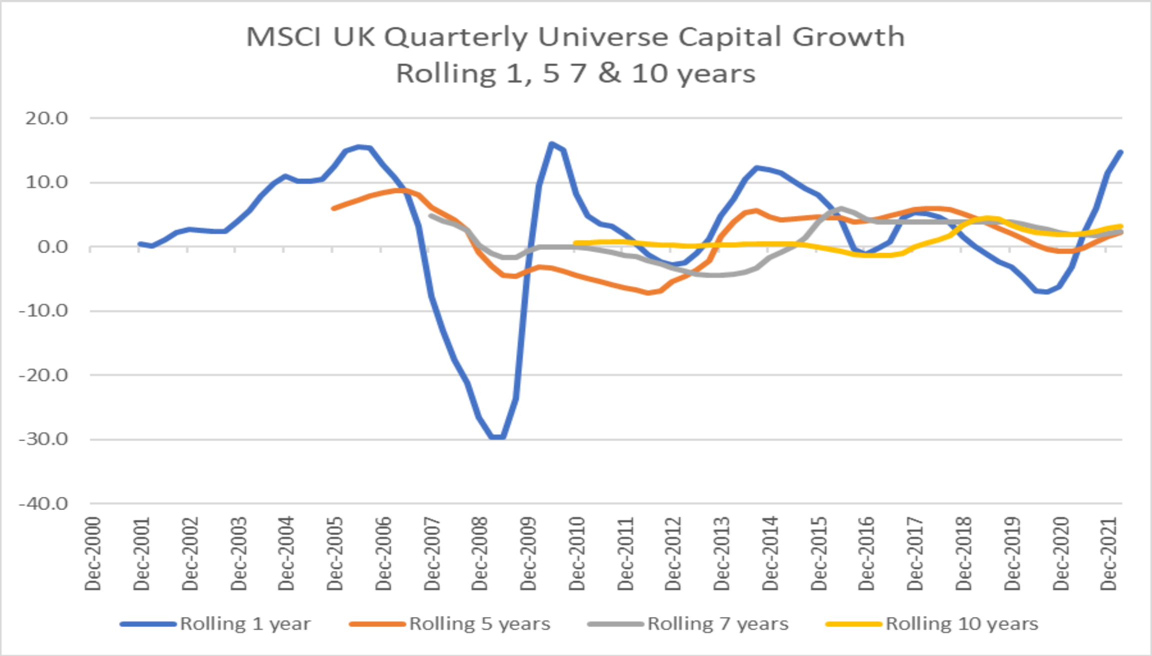
Prior to the introduction of the LTE category, all equities were subject to SCR charges based on short-term volatility. For listed equities this was 39% and for unlisted 49%. There is a volatility dampener of +/- 10%. For equities falling into the LTE category, the SCR charge is now 22%; however, there 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. (see below)

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



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

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.

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 in Solvency II. 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.

Property SCR charge

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-term real estate investments should be eligible to be within an expanded matching adjustment.

LTE category assets

We believe that the current conditions attached to 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. 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. If the current SCR charge for real property risk is not reduced as we propose above, we believe that life insurers should be able to elect whether their long-term real estate investments held directly or in real estate funds are subject to the same treatment as equities falling under the LTE category.

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 also believe that 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.

INREV would be happy to participate in further technical discussions on this matter with HM Treasury and the PRA.

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