Solvency II and IORP update

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Real estate industry interest in Solvency II and Occupational Retirement Provisions (IORP) has waned in recent months with the delays to the EU Parliament vote on the Omnibus II Directive to implement Solvency II. Like the French army at Agincourt, the Directive has become comprehensively bogged down. Progress through the mud has ground to a halt as arrows fly in from all directions. The similarity to the French knights ends there however – despite the barbs and the bogs, the European Insurance and Occupational Pensions Authority (EIOPA) retains its enthusiasm to press forward.

The latest EIOPA round of consultation on Solvency II closed on 19 June 2013. This was in respect of a 'Consultation on Guidelines on preparing for Solvency II' published on 27 March 2013 and consists of a series of guidelines for national regulators that include proposed interim measures in the following areas:

i. System of governance – CP 13/008

ii. Forward looking assessment of the insurer's own risks (based on ORSA principles) – CP 13/009

iii. Reporting to regulators – CP 13/010

iv. Pre-application for internal models – CP 13/011

These are intended to encourage national regulators to adopt consistent approaches in their preparations for implementation. EIOPA is expected to publish the results in the autumn. For the real estate industry, the most significant impact is likely to be in respect of the pre-application process for the approval of internal models and other quantitative aspects and that publication will prompt further Solvency II activity. The consultation assumes that full implementation of Solvency II will be delayed until 1 January 2016 but that Omnibus II will be voted through the EU Parliament in the autumn and that a phased introduction will then follow from 1 January 2014 to 1 January 2016. There is, however, a significant question mark over the timing of the Omnibus II vote. The major issue to be resolved is over the treatment of long-term guarantees. EIOPA has been working on this for several months and published its findings on 14 June. Whilst at one level publication moves things forward, the paper raises more questions and is more likely to delay the Omnibus II vote beyond October than to facilitate it.

The treatment of real estate under Solvency II

In terms of the treatment of real estate as an asset class, despite the best efforts of real estate organisations across Europe in lobbying against the 25% market shock for property, it is highly unlikely that further lobbying on this will yield any benefits. There are, however, other areas of concern for real estate that need to be a focus of attention and lobbying as interest in Solvency II and IORP rekindles in the autumn:

Most large insurers will be seeking approval for their own internally generated models. Although the EIOPA consultation in respect of internal models that recently closed was in respect of guidelines for local regulators rather than insurers, this will clearly, as intended, feed through to those who are being regulated. Further activity by insurers in respect of internal models can therefore be expected in the autumn, and the various real estate industry trade bodies need to be providing as much support as possible to insurers and regulators to ensure as favourable a treatment as possible for property in individual models.

Long-term investments

The treatment of long-term investments under Solvency II is under review. In September 2012, Jonathan Faull on behalf of the European Commission wrote an open letter to EIOPA in relation to insurers as long-term investors. The Commission was concerned to ensure that the market shock provisions under Solvency II do not discourage insurance companies from continuing to provide long-term finance to the European economy. Following this in December 2012, the IPF, INREV and a number of other industry bodies wrote to Director General Faull requesting that real estate should be included in the scope of the EIOPA review of long-term assets. His rather unhelpful response noted that EIOPA is free to recalibrate the solvency capital charge for real estate but declined to request EIOPA to include it in the exercise. The EC expanded on its earlier letter in March 2013 with a Green Paper on the 'Long-Term Financing of the European Economy' (COM(2013) 150/2). Consultations closed on 25 June 2013, with the IPF, INREV and others submitting responses.

Real estate lending

The treatment of real estate lending may be subject to change. The treatment that had been potentially very attractive under the original Solvency II provisions is now significantly less appealing and less logical. The draft implementing measures for Solvency II dated 31 October 2011, which have been widely circulated but never formally published, introduce a significant change to the proposed treatment of commercial real estate lending under the standard market shock formula. In earlier draft provisions, a specific treatment of property loans was included that took account of the value of collateral, using the property shock to adjust the value the collateral. This provision is now restricted to residential mortgages.

Under the 31 October draft, commercial real estate lending has been moved to the general provisions for corporate bonds. The starting point under this provision is a credit rating by a nominated credit rating agency. Bonds and loans for which a credit rating is not available are assigned a risk factor, in an example of presumably unintended humour, termed by the regulator 'F-up'. This does not reflect practice in property lending as individual commercial real estate mortgage loans are generally not rated. Furthermore, it is not clear how collateral should be taken into account. In the absence of any clear provision that would allow collateral to be taken into account, the assumption is that it should be ignored, which would seem to be an odd place for the regulation to end up. There had been a suggestion that this would be subject to further consultation after Omnibus II was passed but this was at a time when this was scheduled for July 2012. It is not clear whether this will still happen with the multiple delays to the EU Parliament vote.

Institutions for IORP Directive

The updating of the IORP Directive should, in theory, introduce Solvency II type provisions for occupational pension schemes. EIOPA is also the body responsible for the technical development of the IORP provisions so it should not have been a great surprise that the starting point for the quantitative impact assessment was the Solvency II equivalent, including the 25% market shock for property.

In a statement on 23 May 2013, Internal Market and Services Commissioner Michel Barnier indicated a change of direction. Whilst it remains his intention, "to come forward with a proposal for a Directive to improve the governance and transparency of occupational pension funds in the autumn of 2013. At this stage, and as long as more comprehensive data is needed and Solvency II is not in force, the proposal for a Directive will not cover the issue of the solvency of pension funds. In light of the differing situations in Member States regarding retirement products and pension funds, it is necessary to continue technical work on the issue of solvency". Many commentators have let out a huge sigh of relief and suggested that the solvency requirements have been postponed indefinitely, but it would be rash not to take Commissioner Barnier's comments at face value. His suggestion that more technical work is required and that this is dependent on the timing of Solvency II should be a clear message to the real estate industry to keep lobbying.

Conclusion

Although Solvency II and IORP may not have been grabbing the headlines over the next few months, things have been moving forward and important developments can be expected during the autumn and next spring. It is important that the real estate industry keeps abreast of developments and maintains its lobbying efforts. The IPF Solvency II Working Group will be sharing further updates in the autumn.