

**Comments Template on EIOPA-CP-11/006
Response to Call for Advice on the review of Directive 2003/41/EC: second consultation**

**Deadline
02.01.2012
18:00 CET**

Company name:	European Public Real Estate Association (EPRA)	
Disclosure of comments:	EIOPA will make all comments available on its website, except where respondents specifically request that their comments remain confidential.	Public
<p>The question numbers below correspond to Consultation Paper No. 06 (EIOPA-CP-11/006).</p> <p>Please follow the instructions for filling in the template:</p> <ul style="list-style-type: none"> ⇒ <u>Do not change the numbering</u> in column "Question". ⇒ Please fill in your comment in the relevant row. If you have <u>no comment</u> on a question, keep the row <u>empty</u>. ⇒ There are 96 questions for respondents. Please restrict responses in the row "General comment" only to material which is not covered by these 96 questions. ⇒ Our IT tool does not allow processing of comments which do not refer to the specific question numbers below. <ul style="list-style-type: none"> ○ If your comment refers to multiple questions, please insert your comment at the first relevant question and mention in your comment to which other questions this also applies. ○ If your comment refers to parts of a question, please indicate this in the comment itself. <p>Please send the completed template to CP-006@eiopa.europa.eu, in MSWord Format, (our IT tool does not allow processing of any other formats).</p>		
Question	Comment	

<p>General comment</p>	<p>The European Public Real Estate Association (EPRA) welcomes this opportunity to provide comments on EIOPA’s draft response to the European Commission’s call for advice on the review of the 2003 IORP Directive. EPRA is the voice of the European publicly traded real estate sector and represents publicly listed property companies, (including REITs), the investment institutions who invest in the sector and the firms and individuals who advise and service those businesses. The institutional investors that EPRA represent include the largest pension funds in Europe with a long track record of investment into the real estate sector. Between them our 200 members represent over €250bn of real estate investments.</p> <p>Given the short time period that has been made available for consultation, our response has focused on general comments and questions raised in Section 11 <i>Investment Rules</i> and Section 20 <i>Risk Management Rules</i>. We hope that these initial comments are helpful in giving you an overview of positions and welcome the opportunity to engage with you further on specific issues.</p> <p>If you have any questions relating to this response to the consultation, please contact Gareth Lewis using the details below:</p> <p>Gareth Lewis – EPRA, Director of Finance T +32 (0)2739 1014 gareth.lewis@epra.com Square de Meeus 23, B1000 Brussels • Belgium www.epra.com</p> <p>Harmonisation of the European pension system & the development of best practices</p> <p>The growth of a sophisticated defined contribution environment is critical for Europe in order to meet the retirement needs of the European population. If Europe is going to have any chance of succeeding in this challenge, there will need to be a rapid evolution of DC schemes in Europe.</p> <p>Throughout Europe, each Member State has its own unique pension system. Harmonisation of such different systems is unlikely to be achieved within a timescale that addresses the critical issues. EPRA</p>	
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therefore welcomes the Commission's previous acknowledgement that pension systems are largely the responsibility of Member States and its focus on internal market and non-discrimination aspects of the subject, rather than attempting to develop a comprehensive regulatory framework.

Our view is that a key objective of any European legislation or guidance in this area should focus primarily on developing and facilitating the rapid, market driven emergence of 'best practice' with respect to the pension plan design and investment rules, rather than an over-emphasis on bringing all member states in alignment with an inflexible European regulatory standard.

We strongly recommend that as part of the development of such best practices, EIOPA and the European Commission look at developments in more established DC environments, particularly with respect to default asset allocations and the recognition of real estate as a separate asset class. It is also important to note that these more established DC environments are themselves evolving as best practice develops and therefore any European framework should be structured with the flexibility to allow for similar market driven development.

The impact of regulation and declining government bond yields

Looking specifically at the current economic environment and the impact of the crises of recent years we observe that regulators have focused increasingly on short-term liquidity and risk (including Solvency II). As a result they are steering insurance companies and pension funds to invest a rapidly increasing proportion of their assets in government bonds. The buying pressure that this has caused has helped contribute to a sharp fall in the available returns from government bonds, as yields have fallen to record low levels.

In an environment where efforts are being made towards a reflationary response to the financial crisis, the regulations as they currently stand are arguably forcing insurance companies and pension funds to take excessive risks with regards to future returns both in a nominal sense (given the low initial yields available on government debt) and in real terms (allowing for the risk of a rise in inflation).

Whilst it is possible that Europe could experience a Japan-style scenario despite all of these reflationary attempts, increased inflation is the obvious way out of the currently over-leveraged economic situation.

Real estate, as an asset class that has a high initial yield as well as the potential for raising rents broadly in line with inflation, has an important role to play in this regard.

The benefits of real estate within pension schemes

Real estate's relatively low volatility and low correlation with other asset classes make it an important source of diversification in any portfolio, reducing overall risk without sacrificing returns. Regulatory frameworks for retirement provision and practices developed in other major global economies – particularly in the US and Australia, have reflected this conclusion and specifically included real estate as an asset class within default investment options. EPRA would be happy to provide research over the last two decades which confirms the importance of real as an asset class particularly suited to pension funds and long term investors.

In addition, there is strong evidence, reflected in the asset allocation decisions taken by the largest global pension funds and through regulation developed in other major world economies that REITs and real estate equities offer a proxy for direct real estate investment that is importantly accessible to all institutional investors, whether large or small.

For the purposes of this response when we refer to 'REITs' we mean publicly listed property investment companies that own, operate, develop and manage real estate assets for the purposes of obtaining returns from rental income and capital appreciation. Due in part to their tax status, REITs have proved to be a successful model for property investment because they create a level playing field with direct investments in property, so that individuals and institutions can invest in this otherwise illiquid and inaccessible asset class, irrespective of their size.

Overriding Recommendation

EPRA have concerns that over-regulation at either an EU or national level could restrict the development of an efficient pension fund sector in Europe and we believe that the prudent person principle is a sufficient regulatory basis for the investment of IORPs. However, EPRA recommend that the European Commission develops some form of best practice guidelines that include a default investment allocation to real estate, for DC pensions, that recognizes REITs as an accessible form of real estate investment. We

	believe that this would ensure that a wider range of pension funds and pension fund holders would be able to access the diversification benefits of real estate.	
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47.	<p>Do stakeholders believe that the prudent person principle is a sufficient basis for the investment of IORPs or is additional provision needed?</p> <p>The response to this question is also relevant to questions 48, 49, 50 and 68</p> <p>EPRA believes that the prudent person principle should remain the basic principle in a revised IORP Directive. It obliges IORPs only to participate in investments that serve the best interests of the beneficiaries. Contradictory as it may seem, it may well be possible that investing in asset classes such as</p>	

government bonds which are labelled as ‘less risky’ or seemingly ‘safer’ investment classes is not in the best longer term interests of the beneficiaries if they do not generate the yields necessary to meet the commitments. This area of discussion is particularly relevant to the role of real estate and real estate equities.

Principles based supervision is therefore preferable to quantitative requirements and we believe that the prudent person principle is a sufficient basis for the investment of IORPs. We have concerns that over-regulation at either an EU or national level could restrict the development of an efficient pension fund sector in Europe.

Nevertheless, EPRA recognize the differences that arise between DB and DC schemes and believe that the European Commission could and should play a very influential role in developing a code of practice, rather than regulation, that identifies best practice guidelines, particularly for DC schemes, that are consistent with the prudent person principle. These guidelines should be particularly applicable "*...where pension schemes provide for....default options (where members in a multi-fund do not make a choice)*" [Response to Call for Advice (RCfA) 7.8.2].

Such a European level code of best practice should be relatively simple and recognize the 4 distinct asset classes of Stocks, Bonds, Cash and Real Estate and the need to include a minimum, or a range of allocations to these asset classes in any properly diversified portfolio. The extent to which these could take the form of ‘safe harbors’, (i.e. categories of default options of a defined standard that, when adopted by IORPs, provide immunity against litigation) suggests a higher level of regulation than a code of practice and is not something we feel comfortable opining on at this stage without further consultation.

We are therefore broadly supportive of EIOPA’s comments at 11.3.1.in the RCfA that: "*when members bear the investment risk, the regulation should not discourage IORPs from offering different investment options, including a low-risk option (and possibly a default option – see below). These options may be defined by bands within which the investment in certain securities have to be kept*"

And we fully support the objective described at 11.3.2. of the RCfA as follows:
"*An alternative to a change to 18(5) is to encourage best practice among Member States in the investment alternatives offered to IORP members who bear the investment risk.*"

	<p>It is our view that the prudent person principle, combined with the EU based best practice guidelines on pension fund design, will achieve an optimal investment result.</p>	
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50.	<p>Do stakeholders agree with the analysis of the options (including the pros and cons) as laid out in this advice? Are there any other impacts that should be considered?</p> <p>The response to this question is also relevant for questions 47,48, 49 and 68</p> <p>Given the format of the RCfA and the number of policy options discussed, it is not entirely clear from the RCfA, what particular option our view aligns with. However, a code of practice (rather than regulation) along the lines described in Q47 above, perhaps with a ‘comply or explain’ approach, would likely be the most effective way to achieving a European-led, efficient DC pension environment. In our view, given the sheer volume and variety of IORPs in Europe, this is the only practical approach.</p> <p>We believe that any European code of good practice should provide pension fund holders with the means to properly access the diversification benefits of real estate as a fundamental asset class that should be included in any properly diversified portfolio. Such a framework should therefore follow the best practices adopted in other developed markets like Australia and the US to recognize listed property companies (including REITs) as a liquid and accessible form of real estate investment.</p> <p>In this respect, we would highlight the clear evidence apparent from developments within the US defined contribution plans towards the inclusion of real estate options within default pension plan options:</p> <ul style="list-style-type: none"> • In the US 401(k) plans offering a real estate option has grown from 4.8 % in 1997 to 33.4% in 2009 [Source: Profit Sharing/401(k) Council of America]. • A 2009 Survey by PIMCO in the US, showed that 66% of firms believed REITs would bring the most value as an added asset class with in defined contribution plans. [Source: PIMCO’s 2009 Defined Contribution Consulting Support and Trends Survey of 32 investment consultants and 	

managed-account-focused firms. Participating firms include 7 of the top 10 investments consulting firms in the U.S.]

Real Estate and REITs

We believe that a sufficient weighting to real estate is very much in the ‘*best interests*’ of beneficiaries (18.1.a) and is "*appropriate to the nature and duration of the expected future retirement benefits*" (18.1.b).

The specific merits of real estate in assisting pension funds to comply with the prudent person principle and its advantages over government bonds are directly relevant to the specific call for advice at 7.9, which raises the question of “The *necessity from a prudential perspective to introduce specific investment rules for pension funds where the members and/or beneficiaries bear risks other than investment risk, in particular biometric risk and inflation risk*" (7.9).

REITs provide a number of other noticeable benefits to investors:

- the professional management of REITs allows investors to allocate to real estate without the need to develop an in-house real estate management team,
- REITs allow investment in pools of quality real estate assets when direct investment opportunities may be lacking,
- REIT investment may be taken on any scale (a problem with direct real estate investment for individuals and smaller pension funds), and
- REITs provide a substantially more liquid avenue for real estate investment.

REITs offer a way of gaining exposure to real estate that is "*properly diversified*" that does not "*expose the institution to excessive risk concentration*" (18.1.e).

The two largest defined benefit pension plans in the US - CalPERS and the California State Teachers Retirement System (CalSTRS), consider REITs as part of their real estate allocations. For example, CalPERS can invest 25% of its target real estate allocation in REITs.

Figure 1 below shows the capability of REITs and real estate equities to contribute solid portfolio performance. US listed REITs (the most established global REIT market) have been the strongest performing asset for the last year, the last three years, the last decade and over the past 15, 20, 25, 30 & 35

year periods (see FTSE NAREIT U.S. Equity REITs TR). Global REITs were the best performing assets for the same periods (for which data exists) with the exception of 5 years (see FTSE NAREIT U.S. Equity REITs TR).

Figure 1:

All figures in %	FTSE NAREIT U.S. Equity REITs TR	FTSE EPRA/NAREIT developed TR	S&P 500 TR	MSCI EAFE TR	Barclays Capital U.S. Aggregate Bond	Barclays Capital Global Aggregate Bond
1-Year	8.14	-0.81	7.83	-4.12	5.52	6.31
3-Year	25.35	19.42	14.13	10.11	7.69	7.95
5-Year	-2.65	-4.94	-0.18	-3.95	6.14	6.04
10-Year	9.95	9.70	2.91	4.83	5.59	6.86
15-Year	9.29	6.46	5.24	3.37	6.18	5.74
20-Year	11.04	8.57	8.34	4.88	6.60	6.60
25-Year	9.72	NA	9.12	5.63	7.15	NA
30-Year	11.77	NA	10.84	8.86	8.80	NA
35-Year	13.03	NA	10.70	10.01	8.13	NA

Note: Data as of November 30, 2011
Formerly Lehman Brothers U.S. Aggregate and Global Aggregate Bond Indexes
Sources: NAREIT® analysis of data from IDP accessed through FactSet.

REITs and real estate equity returns have a low correlation to all non property stock returns. Correlation coefficients for global listed real estate equities, based on monthly data, June 1994 – November 2011 are shown in Figure 2 below:

Figure 2:

	FTSE EPRA/NAREIT Developed Real Estate Index	
MSCI World Large-cap growth 67.1%	MSCI World Large-Cap 76.7%	MSCI World Large-Cap Value 81.7%
MSCI World Mid Cap Growth 66.7%	MSCI World Mid Cap 80.5%	MSCI World Mid-Cap Value 86.8%
MSCI World Small-Cap Growth 72.3%	MSCI AC World Small Cap 81.4%	MSCI World Small-Cap Value 87.2%

Note: Based on monthly returns, Source: NAREIT®

An analysis of the correlation of various stock market sectors (Tech, Consumer Discretionary, Consumer Staples, Utilities) with broad stock market returns show that, whereas correlations between these market sectors and broad stock market returns increase with investment horizon, correlations between REITs and broad stock market returns decline over time [Source: NAREIT® analysis of monthly returns data for January 1990 through November 2011 from Interactive Data accessed through FactSet].

These declining REIT-stock correlations, over increasing investment horizons, indicate that asset returns increasingly differ as mispricing effects are corrected. Declining correlation, as errors are corrected, is a sign that underlying return drivers are fundamentally different - that is, REITs and non-REIT stocks represent different asset classes.

As discussed in our response to Q67, one of the key reasons why REITs and listed real estate equities are favored in the most advanced lifecycle funds and DC schemes in general, as a means to manage real estate exposure in life-cycle funds, is because the liquidity they provide (to an otherwise illiquid asset class) enables fund providers to ‘ensure that the change in asset mix happens efficiently’ [20.3.30(b)]. EPRA strongly believe that any default allocation guidelines developed at an EU or national level should include the ability for a pension fund provider to manage its real estate exposure using allocations to REITs and listed real estate equities.

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68.	<p>What is the view of stakeholders on the proposed principles of the revised IORP directive? How do stakeholders evaluate the positive and negative impact of the proposed risk management principles?</p> <p>The response to this question is also relevant for questions 47,48, 49 and 50</p> <p>As the RCfA identifies, ‘life-cycling’ as an investment strategy in DC schemes can be an important risk-diminishing technique and this has been evidenced through global market developments. We fully support the statements at 11.3.61 that identifies DC pension plan ‘best practice’ of offering a number of investment options, with at least one low-risk option; the introduction of life-styling of the investment and the introduction of default options for the members not making the choice.</p> <p>We have some concerns with the RCfA statement at 11.3.66 that "default options that comply with [life-styling] principles should be considered as a 'safe harbour' by national legislation". If these principles, and the existence of the safe harbour, compel a narrow strategy of investing progressively more of a pension capital into government bonds the closer one approaches retirement, there is a risk that a focus on these</p>	

assets could expose the pension fund to unacceptably high investment risks both in terms of initial yields and vulnerability to rising inflation (see introductory comments – Q1).

Evidence from global markets have shown that the investment performance of real estate and real estate equities, including REITs, have been characterized by high and stable dividends, competitive total returns, inflation protection, and low to moderate correlation with other assets. The combination of these investment characteristics offers the potential for important portfolio diversification benefits specifically for life-cycle funds:

- Of the 27 investment managers in Callan’s Target Date Fund survey, 73% were using real estate in the target date funds [Source: 2009 Callan Target Date Fund Manager Survey, May 2009]
- The percentage of target-date)fund companies investing in REITs increased from 26% in 2005 to 54% in 2007. [Source: “Mutual Funds: Future Outlook for Lifecycle Funds; Insights into Emerging Trends and Growth Opportunities”, Financial Research Corporation study, May 23, 2008]

Figure 3 below shows the maximum real estate allocations from a product manufacturer perspective, used by selected organizations for lifecycle and target-risk funds.

Figure 3.

Organization	Maximum Real Estate Allocation	Allocation Type
PIMCO	15.0%	Domestic
UBS	15.0%	Global
JPMorgan	12.0%	Global
Alliance Bernstein	10.0%	Global
Dow Jones Indexes Real Return	10.0%	Domestic

Source: NAREIT®

One of the key reasons why REITs and listed real estate equities are favored in existing lifecycle funds and DC schemes in general, as a means to manage real estate exposure in life-cycle funds, is because the

	liquidity they provide (to an otherwise illiquid asset class) enables fund providers to ‘ <i>ensure that the change in asset mix happens efficiently</i> ’ [RCfA 20.3.30(b)]. EPRA strongly believe that any default allocation guidelines developed at an EU or national level should include the ability for a pension fund provider to responsibly manage its real estate exposure using allocations to REITs and listed real estate equities.	
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