

FIVE REGULATORY REFORMS THAT WILL CHANGE REAL ESTATE INVESTMENT

The next few years will see the introduction of five key pieces of legislation which will profoundly change the way that stakeholders in the real estate investment market operate. Investors, fund managers, insurers, banks and tenants will be faced with new demands from a rapidly evolving regulatory environment.



Chris Urwin

Global Research Analyst, Aviva Investors - United Kingdom

Joined the investment industry in 2009.

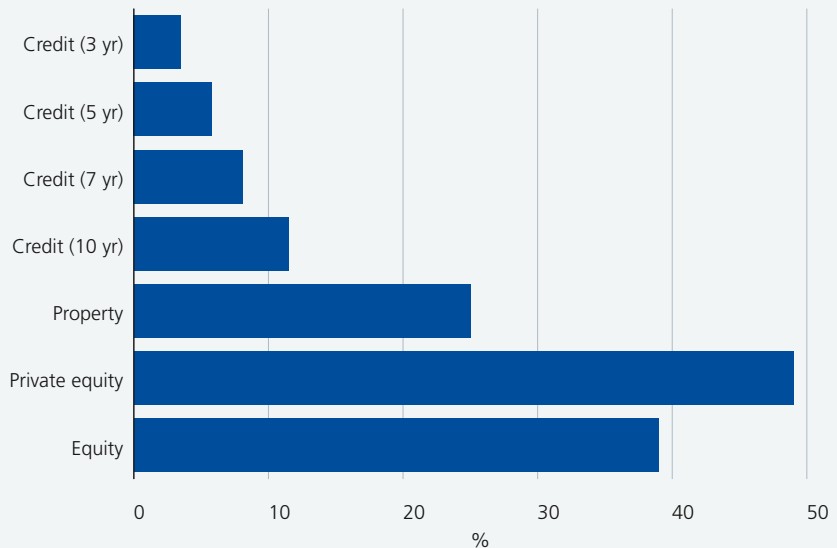
Main responsibilities

Chris develops views of markets and sectors and also prepares key strategy and research reports to aid investment decision making.

Experience and qualifications

Previously, Chris worked for CBRE where he was a senior analyst. Prior to that he worked for the Institute of Public Policy Research Centre for Cities as an economist and has also worked as an assistant economist with HM Customs and Excise. Chris holds an MA in economic history, and is a member of the Society of Property Researchers.

Figure 1. SII standalone standard solvency capital requirement by asset class



Source: Morgan Stanley Research, Oliver Wyman, September 2010

Equity and private equity capital charges reflect long-term capital requirements (i.e. without equity dampener). For credit, calculations are based on the model portfolio specified in QIS5 draft specification, assume that all assets are invested in this model portfolio and focus on credit spread capital. Interest rate risk/asset liability duration mismatch capital requirements are not considered.

1. Bank of America Merrill Lynch, 2010.

Until they have been finalised, it is difficult to predict the implications of each of these complex pieces of legislation, vis:

- Solvency II
- Basel III
- Changes to lease accounting
- The Alternative Investment Fund Managers Directive, and
- European Market Infrastructure Regulation.

One conclusion, however, seems inescapable. Given the dominant role that regulators and legislators will play, organisations with a strong understanding of the issues involved and the ability to adapt will have a competitive advantage.

Solvency II (SII)

SII provides a legal framework for managing the risks and solvency positions of insurers in the European Union. It aims to ensure that insurers hold sufficient capital to support the business they write (i.e. to meet their commitments to policyholders), even in the event of a one-in-200-year shock to asset prices. The legislation is intended to increase consumer protection through a risk-based approach to calculating capital requirements and a consistent approach to calculating insurance liabilities. SII will culminate in a European Directive for implementation into national law, potentially by 2014.

SII is likely to have a profound effect on the investment patterns of European insurers, which currently hold assets worth €7 trillion. Under SII, the riskiness of every asset held on the balance sheet will be taken into account, and riskier assets will attract higher capital requirements. This is shown in Figure 1. Insurance companies will be required to hold cash or highly-rated bonds to meet these capital requirements. Insurers are already making changes to their asset allocations: equity holdings have fallen over the past two years, while holdings of government bonds and short-dated credit have increased.

SII and real estate

Real estate investments account for less than five per cent of total insurance company assets¹. However, real estate will not be immune to the changes.

Direct real estate: The proposed stand-alone capital charge for direct real estate is 25 per cent, while development activity is likely to be treated as private equity risk, with a capital charge of 49 per cent. The amount of capital that insurers will actually need to hold will depend on the assumed correlation of direct real estate performance with other risk assets, which are higher than we would expect. For example, the correlation between property and equities is set at 0.75. The stand-alone charge is based on the UK market experience, which is more

volatile than many other European markets, so insurance companies that do not hold 100 per cent UK real estate could argue that the capital charge is too severe. Diversification by sector and geography are also ignored, so the same charge could apply to portfolios of Madrid offices or Munich residential property.

Indirect real estate: Listed real estate securities carry an equity charge of 39 per cent for companies listed on regulated markets in European Economic Area (EEA)/OECD countries, or 49 per cent for non-EEA/OECD companies. Leverage appears to reclassify real estate as private equity, with a capital charge of 49 per cent. This would encourage investment in highly leveraged funds because capital charges apply to net asset value (NAV), not gross asset value (GAV) – so a fund with leverage of 90 per cent would be more capital efficient than one with ten per cent leverage.

Overseas real estate holdings: Overseas real estate carries a higher capital requirement than domestic real estate because, in addition to covering property risk, insurers are required to hold capital to cover currency risk.

Lending: Investment in property through mortgages will probably be capital efficient, with residential and commercial mortgages carrying a capital requirement of less than ten per cent.

REaLM (returns enhancing and liability matching) assets: The SII stress tests are applied to the difference between assets and liabilities, so asset-liability matching approaches are likely to become more popular. Capital requirements may be less burdensome for assets that match liabilities well, and for some insurance companies REaLM assets, such as social housing, may be more attractive than traditional real estate.

Basel III

Basel III is a series of reforms to the Basel Committee on Banking Supervision's international prudential framework for capital requirements. The reforms are designed to reduce the probability and severity of future financial crises. Basel III strengthens the quality and quantity of capital and risk coverage and introduces some new prudential requirements.

Basel III is likely to affect all credit institutions and investment firms, and

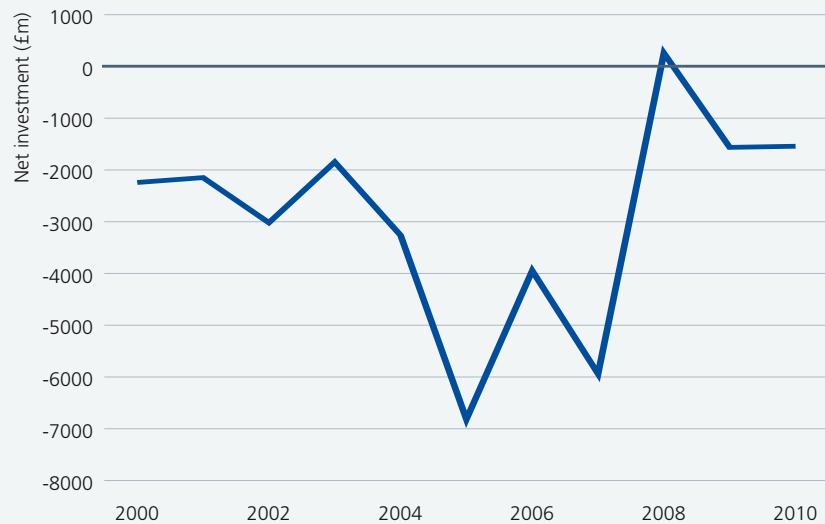
banks are already responding by building their capital and de-risking. The extent to which the reforms will be legally binding will depend upon how they are implemented by national authorities, and the reforms will be implemented over a period of almost ten years.

Basel III and real estate

Lending costs are expected to increase under Basel III as a result of the costs of complying with the new legislation. With stricter capital adequacy requirements, banks will either be able to lend less with the same capital, or they will need more capital in order to maintain their current lending levels.

Real estate values tend to increase when debt finance is plentiful and decline when debt finance is constrained. Given that many lending institutions are seeking ways to reduce the proportion of real estate loans on their books, a decline in the availability of debt over the coming years will be unwelcome. However, new sources of debt are emerging to meet demand, with several insurance companies stepping up lending and the appearance of mezzanine finance funds focused on the real estate sector.

Figure 2. Net investment by occupiers, UK, 2000-2010



Source: PropertyData.com, December 2010

2. Under the current lease accounting model, leases are classified as either operating or financing leases. Finance lease accounting relates to the financed acquisition of an asset. The lessee records the asset on its balance sheet, together with a liability equal to the present value of the minimum lease payments. For an operating lease, the lessee records nothing on the balance sheet. Operating leases are seen as a form of off-balance sheet financing, because the lessee has incurred an obligation to make payments but records no liability. On the income statement, the payments under the lease are expensed each period.

3. AIFMD proposals include:
- Disclosure and monitoring of leverage and potential limits on leverage at the fund level.
 - Minimum levels of service and information for investors.
 - Conduct of business requirements, including provisions for treating investors fairly.
 - Minimum capital requirements
 - Restrictions on the delegation of functions such as portfolio management.
 - The ability to passport and market funds in other EU member states.

Lease accounting

The Financial Accounting Standards Board and International Accounting Standards Board propose to remove the distinction between operating and finance leases. Instead, all leases would be reflected on the lessee's balance sheet². This change would have major implications for real estate management and investment decisions. The implementation date is unconfirmed, but it is unlikely to take effect before 2013.

Lease accounting and real estate

Lease accounting changes could affect how companies make real estate decisions and the availability of stock for real estate investors. There might be greater owner occupation, because owning could become more financially attractive than leasing. As Figure 2 shows, the past decade has seen largely negative net investment by occupiers, implying that occupiers sold more property (by value) than they bought. This is likely to change under new lease accounting rules. As a result, the pool of property available to real estate investors could shrink, potentially driving up values. This, in turn, might reduce potential for portfolio diversification, or reduce access to suitable real estate for asset-liability matching. Lease lengths could shorten, increasing volatility of returns and costs to the landlord. However, shorter leases could also benefit landlords by allowing them to manage their assets more actively (through regular refitting, for example)

and remove under-performing tenants more frequently.

The Alternative Investment Fund Manager Directive (AIFMD)

The AIFMD proposes new regulatory standards for alternative investment fund managers (AIFMs) across Europe. It aims to bring consistency of standards, improve financial sector stability and deliver better protection and wider choice for investors through a series of proposals³.

The directive is expected to be implemented by EU member states by early 2013 and reviewed in 2017. It applies to all EU-based AIFMs above a certain size and affects a wide variety of alternative investment fund (AIF) types, including hedge funds, private equity and venture capital funds, real estate funds and investment trusts. Funds which are regulated under the UCITS Directive are excluded from AIFMD, as are insurance companies and credit institutions.

AIFMs that meet authorisation requirements should benefit from greater investor confidence in their funds and the ability to market funds to investors in multiple EU states through "passporting" provisions. This should expand investors' options and increase competition and market efficiencies.

AIFMD and real estate

More than 90 AIFMD implementation measures are still under development,

and these will define the impact of AIFMD on real estate. However, it is clear that few real estate funds will qualify for exemption.

Real estate funds' performance is unlikely to be altered by the new regulations, unless numerous participants were to withdraw from or enter into the market, or radically change their investment strategies. It is difficult to see this being the case. Indeed, the directive should benefit investors and AIFMs because passporting could increase choice and economies of scale by reducing the need to launch multiple funds across different jurisdictions.

AIFMD rules on liquidity and leverage, which are designed to reduce systemic risk, encourage funds to reduce gearing levels, and this could have negative implications for some AIFMs. However, many funds are already actively pursuing strategies with lower gearing, either because of a lack of available finance or pressure from investors.

Complying with the directive will add to the costs of running AIFs, but this is unlikely to deter investors from choosing these vehicles. The FSA estimate that AIFs will incur total one-off costs (mainly legal costs) of €451m (23.2bps) and ongoing costs of €3m (0.2bps)⁴.

European Market Infrastructure Regulations (EMIR)

Following the collapse of Lehman Brothers in 2008, the G20 nations decided to reduce the systemic risks of derivatives, primarily by requiring all over-the-counter (OTC) derivatives to be cleared by a central counterparty (CCP). While the practical implications of proposed derivatives legislation in the EU and US cannot be assessed until details have been finalised, the proposed EU legislation would require eligible OTC derivatives to be cleared through CCPs and the counterparties to post collateral equivalent to initial and variation margin.

EMIR also introduces reporting obligations so that information on the risks inherent in OTC derivatives markets will be stored centrally and easily accessible, and sets forth requirements for risk mitigation techniques to measure, monitor and mitigate operational and credit risk. EMIR could apply from the end of 2012.

EMIR and real estate

EMIR could require a swathe of real estate investors to rapidly alter their gearing strategies. This could produce general instability in real estate markets. Assuming that real estate funds will fall under EMIR, together with property total return swaps and interest rate swaps, the potential implications are far-reaching. There is

4. FSA, "The Impact of the AIFM Directive", October 2009.

a real possibility of funds moving to jurisdictions with less onerous regulations.

Imagine the impact on geared property funds if they were required to quickly collateralise deeply out-of-the-money interest rate swaps. If existing cash reserves were insufficient, forced asset sales or expensive borrowing might be necessary, leading to a higher cost of capital. This could increase market cyclicality, with small downturns causing a dramatic increase in would-be sellers. Funds would have strong incentives to leave interest rate exposure unhedged, while also decreasing gearing and reducing fund size, which could have negative implications for diversification.

Conclusion

Regulations and regulators will be a salient feature of the investment landscape for the rest of this decade, and probably beyond. All the legislation currently being proposed is motivated by a strong desire to improve the safety and efficiency of markets for all participants. However, the challenge of getting to grips with the new legislation adds additional complexity to the task of deciding which exposures are most appropriate and which vehicles and jurisdictions offer the best routes to implementing strategies.

We believe that fund managers who understand and appreciate the effects of the rapidly approaching confluence of new legislation will have a major competitive advantage that should provide tangible benefits for their clients. As one of the largest investors in European real estate markets, Aviva Investors will continue to work with regulators and industry bodies to promote regulatory solutions which benefit our clients and other market participants, and help ensure the long-term health of the real estate industry.

Key points

- Five new pieces of legislation are set to alter the way that investors, fund managers, insurers, banks and tenants make real estate decisions.
- The complexities and sweep of the new legislation add materially to the challenges of allocating assets and selecting appropriate investment vehicles and jurisdictions.
- It is difficult to assess the full implications of the new legislation until it is finalised.
- However, fund managers who understand the implications of the new legislation will have a major competitive advantage.
- Awareness of regulatory issues is now a key element in managing risk and return.

Contact us at
Aviva Investors North America
215 10th Street, Suite 1000
Des Moines, IA 50309

Aviva Investors North America
375 Park Avenue, 21st Floor
New York, NY 10152

Aviva Investors North America
300 North LaSalle Street, Ste 1600
Chicago, IL 60654

Aviva Investors North America (AINA) represents the North American region of affiliated asset management business operating under the Aviva Investors North America name. AINA is comprised of three legal entities, each of which is an indirect subsidiary of Aviva plc: (i) Aviva Investors North America, Inc., an SEC-registered investment adviser with offices in Des Moines, Boston, Chicago, New York, (ii) River Road Asset Management, LLC, a registered advisor headquartered in Louisville, KY, and (iii) Aviva Investors Canada Inc., the Aviva Investors affiliate headquartered and operating in Canada.

The name "Aviva Investors" as used in the Presentation refers to the global organization of affiliated asset management businesses operating under Aviva Investors name. Each Aviva Investors North America affiliate is a subsidiary of Aviva plc, a publicly-traded multi-national financial services company headquartered in the United Kingdom.

Past performance is not indicative of future results. Investing in bonds or other securities is subject to certain risks, including market, interest-rate, issuer, credit, and inflation risk.

Opinions expressed herein were drafted as of the date of this article, and are subject to change without notice. This material has been distributed for informational purposes only and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product.

No chart, graph, model, or other figure or formula, whether provided in this article or elsewhere, should be

used to determine which strategies to implement or which securities to buy or sell.

Any statement concerning financial market trends is based on current or past market conditions which can fluctuate over time. Information contained herein has been obtained from sources believed to be reliable, but the accuracy of such information is not guaranteed by the author or Aviva Investors.

No part of this material may be reproduced in any form, or referred to in any other publication, without advance express written permission.

No chart, graph, model, or other figure or formula, whether provided in this article or elsewhere, should be used to determine which strategies to implement or which securities to buy or sell. Every investor should determine, in consultation with the investor's own advisors, the economic, legal, tax, regulatory and accounting issues and consequences of any investment strategy. There can be no guarantee that any strategy discussed in this presentation will achieve any given investment objective; with any investment strategy, all or a portion of the investment is at risk and may be lost.

No Aviva Investors company is soliciting business, holding itself out as being in the business of, or engaging in the business of, providing investment advice or buying or selling securities in any jurisdiction or for any client if such activities are not permitted under applicable law.