Institute and Faculty of Actuaries

30 December 2019

PRA CP23/19 Solvency II: Income producing real estate loans and internal credit assessments for illiquid, unrated assets - IFoA Response

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Key points

Although the bulk of the consultation considers specifically Income Producing Real Estate (IPRE) assets, we note that the principles outlined in the draft Supervisory Statement SS3/17 are applicable more widely to other illiquid or private credit assets. We thus believe the scope of the PRA's revised expectations could be defined more broadly, rather than outlining expectations with regards to one particular asset class (IPRE). As currently drafted, SS3/17 could imply greater regulatory scrutiny of IPRE versus other, similar assets, such as infrastructure loans.

We also note that at times different external credit assessment institutions may have different rating methodologies between them for the same asset class. We suggest that where a published methodology/(ies) exists, the internal credit assessment is benchmarked against it, to ensure it results in a plausible range of Credit Quality Steps.

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1. The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to respond to the PRA's Consultation Paper CP23/19 on Income Producing Real Estate (IPRE) loans and internal credit assessments for illiquid, unrated assets.

2. The CP is helpful in setting out the PRA's proposed expectations in relation to risk identification and modelling of IPRE assets within firms' Solvency II internal models, along with clarification of expectations on internal credit assessment more generally. We have a number of points of constructive feedback, including on the proposed revised Supervisory Statement SS3/17, which we hope the PRA finds helpful. It is important to note that, as for any IFoA consultation response, we have considered the proposed expectations from the perspective of the public interest.

   Note that all paragraph references relate to the draft amended SS3/17 in the CP Appendix.

3. Although the bulk of the CP considers specifically IPRE assets, we note that the principles outlined in Section 4 (Risk identification and modelling of IPRE loans) are applicable more widely to other illiquid or private credit assets. This view appears to us to be consistent with paragraph 4.1:

   'However many of the expectations could be applied more widely to other less liquid assets…'

4. We thus believe the scope of the PRA's revised expectations could be defined more broadly, rather than outlining expectations with regards to one particular asset class (IPRE). Our concern is that firms could regard the current proposed expectations as indicating greater regulatory scrutiny of IPRE versus other, similar assets, such as infrastructure loans. This could potentially hinder investment in this well-established asset class (i.e. IPRE).

5. We also note that IPRE loans have been referred to as either Commercial Real Estate (CRE) loans or Commercial Mortgage Loans (CMLs). The introduction of new terminology may therefore be somewhat confusing, unless it is clearly defined. It would be useful to provide greater clarity on what assets come within scope of the requirements; for example, would ground rents or loans to social housing be classified as IPRE?

6. We refer to paragraph 2.8B: *'There should be a detailed description of **all the risks** affecting each asset and the firm has satisfied itself that it has considered **all potential sources** of systemic and idiosyncratic risk…' (our emphasis).* We suggest this requirement should refer to the materiality of the risks concerned.

7. More generally, the proposed requirements might appear disproportionate for firms wishing to first enter this area of investment in a limited fashion, with the requirements perhaps being more appropriate for firms with material holdings of such assets.

8. Paragraph 2.8D includes the following:

   '- set out the scope of risks covered and define the credit and other relevant risks being measured and, where an ECAI has a published credit rating methodology for an asset class, have in scope at least the same range of risks, qualitative and quantitative factors and risk mitigating considerations;..'

9. We note that at times different ECAI may have different rating methodologies between them for the same asset class. We therefore feel the above requirement may be too strong and may not be very practicable. Instead, we suggest that where a published methodology/(ies) exists, the internal credit assessment is benchmarked against it, to ensure it results in the plausible range of Credit Quality Steps (CQS) - as required by paragraph 2.8G. If different risk factors are used, we would expect firms to explain the reasons for such differences.

10. We do not understand the purpose of the reference to Special Purpose Vehicles (SPVs) in paragraph 4.3. Whilst the observation made is reasonable, drawing attention to SPV structures might create an impression that such an approach is preferred by the PRA.

11. As we mention above, we think the materiality of risks has a bearing on risk assessment, and this could be referred to in paragraph 4.7.

12. The wording of paragraph 4.24 suggests to us that there may be a greater risk of misaligned interests between a firm and its investment manager in relation to IPRE or illiquid credit assets. Although we agree that such assets could give rise to misaligned interests, we do not think these are necessarily greater risks than for any outsourcing activities generally. The emphasis in the paragraph could therefore be adjusted to reflect this.

13. In paragraph 4.38, we believe the stressed property values and valuation risks in item (i) could be a function of the components (ii) and (iii) listed. This means that care is needed to avoid any double-counting of risks.

Should you want to discuss any of the points raised please contact Steven Graham, Technical Policy Manager (steven.graham@actuaries.org.uk) in the first instance.

Yours Sincerely,

Tan Suee Chieh

President Elect, Institute and Faculty of Actuaries