VIEWS

March 2017

EPRA response to the European Commission's public consultation on the Capital Markets Union (CMU) mid-term review 2017

Background

After two years from the introduction of the CMU project, the Commission aims to publish the Mid-Term Review of the Capital Markets Union (CMU) Action Plan in June 2017. As part of its preparation, the Commission has the chance to assess what actions could be reframed in the light of evolving market circumstances.

EPRA responded to the consultation and took the opportunity to provide an input needed to help improve the conditions of the listed property sector. It is our view that the European listed property sector needs:

- a more neutral and investment-friendly tax system;
- more inward and intra-EU investments;
- Europe to work smarter to fill the pensions gap; and
- the withholding tax refund procedures improved as they prevent cross-border investments.

We at EPRA emphasized importance of the listed (more liquid) real estate as an asset class to investors. Indeed, EPRA's research showed that including listed property investments in the right range of assets can generate greater returns (UK and German examples). This should be considered ahead of the upcoming pan-European personal pensions products initiative. Here we agree with the insurance sector that investing in right range of assets can be as important as saving enough.

B. Making it easier for companies to enter and raise capital on public markets

Are there additional actions that can contribute to making it easier for companies to enter and raise capital on public markets?

Please propose complementary policy measures, explain their advantages, and illustrate any foreseeable challenges to their implementation.

INVESTMENT-FRIENDLY TAX SYSTEM IN EUROPE

We agree with the Commission that Europe needs to create a more neutral and investment-friendly tax system to build a successful CMU and to attract inward investment to the EU. We also agree that there are currently tax distortions against equity financing. The Commission's Common Consolidated Corporate

Tax Base (CCCTB) proposals seem to be a good step forward. Nevertheless, we need to point out that certain aspects of the proposed rules might have an unintended adverse impact on the sector we represent. If not revised, more hurdles could be placed on Real Estate Investment Trusts (REITs).

To introduce the sector, we would like to mention that real estate investments through the stock market take place within professionally managed organisations with a high financial and governance transparency, offering investors in the shares of such companies (e.g. pension funds, insurance companies) enhanced liquidity as well as opportunities for portfolio diversification. Considering Europe's current challenges, such as a low interest rate environment or an increasingly aging population, we should be careful not to strangle the growth of European capital markets and the listed real estate sector with undue regulation.

In addition, investing in real estate through capital markets helps create stable and balanced domestic real estate markets. 13 governments in Europe have recognised a public benefit to incentivise real estate investment through the capital market and have introduced REIT regimes to maximise returns through an effective pass-through for tax purposes. This number will continue to grow.

However, we are concerned that the C(C)CTB proposals could have unintended (and potentially) adverse consequences on REITs which have an important role to play in keeping domestic real estate markets stable and balanced.

1. **Possible distortion of REIT regimes in Europe**

If the CCTB and later CCCTB rules apply to REITs, national tax rules in some jurisdictions will cease to apply as far as the tax base calculations are concerned. This might unintentionally result in a disruption of some of the national REIT regimes because the mechanisms that ensure REITs have a tax effective pass-through status vary from country of country and sometimes relate to the corporate tax base calculations, instead of the tax rates. However, where there are tax rates related, these should be preserved.

That said, we are concerned that the C(C)CTB rules might result in a greater distortion rather than an intended harmonisation of tax rules impacting REIT regimes.

2. **Possible adverse impact on EU REITs attractiveness for investors**

We are also concerned about what impact it may have on EU REITs attractiveness for institutional investors in those jurisdictions (e.g. France, Spain, Italy).

3. **Impact on real estate markets in EU member states have not been assessed**

We saw no reference to the real estate sector in its Impact Assessment. It failed to recognise specificities of listed real estate sector. Therefore, we recommend to proceed with caution with untapped rules which could adversely impact real estate markets in EU member states.

4. **Unclear consolidation**

It is equally unclear how a consolidation of the C(C)CTB rules can be performed by applying the rules which are not applicable on all the companies forming a group. This is because there will be situations where the effect of REIT rules means that only some of the companies within a single group will be subject to the new rules.

5. **Complexity of rules for REITs**

We share the views of Accountancy Europe that lawmakers have a clear obligation to ensure that legislation is clear and precise, thus ensuring that taxpayers can fully and easily comply with their tax obligations. As much as we welcome the C(C)CTB rules in principle, we are not convinced that they are fit for the sector we represent as they could lead to an unreasonably complex outcome for REITs that operate across borders.

6. **Property is a capital-intensive business**

Property is a very capital-intensive business, and the private sector will always be needed to play an essential role in delivering long-term capital investment and expertise to meet Europe's real estate and infrastructure needs. Publicly listed property companies, including REITs, perform a leading role in delivering the property sector's contribution to the real economy. They are long-term players in the largest, most innovative, ambitious but also capital-intensive projects.

EPRA report 'Stock Exchange Listed Property Companies: Building a Stronger Europe' contains more information.

RECOMMENDATIONS

We therefore recommend the Commission to acknowledge that the listed real estate sector, including REITs, present special features which call for a more customised approach.

We recommend that companies under special tax regimes fall outside the C(C)CTB scope following Article 2(4).

A full text of EPRA's policy paper on CCCTB is attached.

C. **Investing for long-term, infrastructure and sustainable investment**

Are there additional actions that can contribute to fostering long-term, infrastructure and sustainable investment?

Please propose complementary policy measures, explain their advantages, and illustrate any foreseeable challenges to their implementation.

PROPERTY: A PLATFORM FOR THE ECONOMY

The built environment – the space and infrastructure that provides for the needs of businesses, families, hospitals, schools, and leisure activities – is fundamental to Europe's well-being by catering to its economic and social needs. The EPRA/INREV report 'Real Estate in the Real Economy' further explains how the commercial property sector contributes to Europe's economy, businesses, and citizens.

INVESTING TO LISTED PROPERTY COMPANIES: LONG-TERM & SUSTAINABLE BENEFITS FOR EUROPE

Investing in real estate through capital markets helps create stable and balanced domestic real estate markets. It can contribute directly and substantially to the objectives of the European Union and its member states by delivering the following benefits for Europe:

- **Efficient delivery of Europe's built environment**
- **Broader access to high quality commercial real estate for the whole spectrum of investors**
- **Improved market stability and lower systemic risk**
- **Improved transparency**
- **Accelerated development of a sustainable built environment**

REGULATORY IMPEDIMENT TO THE FINANCING OF LONG-TERM INVESTMENT

Impact of Solvency II on long-term investment decisions of insurance companies

Institutional investors such as insurance companies invest in real estate as part of their long-term investment allocation. Regulatory requirements are one of the key determinants as regards their investment decisions. Classification of the various methods of allocating capital to real estate as either direct, indirect and application of the 'look-through' under the Standard Model restrict the ability for insurance companies to allocate capital in real estate through the stock market.

We would therefore view the unintended consequence of the existing prudential regulation in the fact that insurance sector investment into real estate overwhelmingly occurs directly or through more opaque investment funds. This generally results in producing a higher concentration of assets and lower liquidity. Investments from the insurance sector into real estate are flowing. However, not through the more open, more transparent, more liquid and advantageous form of investment by way of shares of professionally managed property companies listed on stock exchanges. We believe that this would better service the public interest both in terms of creating a better result for the ultimate beneficiary of the investment, the policy holder, as well as the society at large.

EPRA recommendations for the upcoming review of Solvency II

We propose the European Commission to review the framework and guidance for Solvency II so as it does not unduly restrict the ability for insurance companies to gain an appropriate level of exposure to the listed real estate sector. We propose the European Commission to address the Solvency II provisions which excessively encourage short-term investment behavior. Instead, we need you to thoroughly look at how to encourage financing of the long-term investments.

We therefore ask the Commission to consider the EPRA recommendations and address this regulatory burden. We suggest an additional category under a 'standard equity risk-sub-module' in Article 169 (1) of the SII Delegated Regulation (EU) 2015/35 while understanding investments to Real Estate Investment Trusts (REITs), which meet a set of minimum criteria, as strategic long-term investments.

Minimum requirements for REITs could consist of e.g. legal form, listing requirements, mandatory distribution of income.

Requirements for strategic long-term investments into REITs could consist of (as inspired by Article 171 of the SII Del. Reg.) the following:

(a) That the value of the equity investment is likely to be materially less volatile for the duration of the investment that the value of other equities over the same period as a result of the nature of investment;

(b) That the nature of the investment is strategic, taking into account all relevant factors, including:

   i) The existence of a clear decision to continue holding the participation for a long period (at least 18 months);

   ii) The participating undertaking's ability to continue holding the participation in the related undertaking;

   iii) The REIT's continuous ability to meet its qualifying criteria (listed above);

   iv) Where the insurance or reinsurance participating, company is part of a group, the consistency of such strategy with the main policies guiding or limiting the actions of the group.

Such long-term investments to qualifying REITs of a strategic nature should then be decreased to the sum of 22% which is equal to that for investments of a strategic nature as per Article 169 (1)(a).

GICS/MSCI – 11th category

In addition, Real Estate was moved out from under the Financials Sector under the Global Industry Classification Standard (GICS) and being promoted to its own Sector under the code 60. The REITs Industry is being reclassified to Equity REITs because REITs characteristics differ from the financials sector.

D. Fostering retail investment and innovation

Are there additional actions that can contribute to fostering retail investment?

ACCESSIBILITY FOR RETAIL INVESTORS

Around 40% of all commercial property is held as an investment by various types of investor – listed property companies, private property companies, non-listed funds and institutions. Only listed property companies, including REITs, are accessible to all types of investors.

PAN-EUROPEAN PERSONAL PENSIONS (PEPP)

Europe is facing a major challenge in ensuring adequate retirement income for its citizens in an environment of low growth and low interest rates. It's therefore crucial to face this challenge correctly. We at EPRA welcome the Commission's plans to create a Pan-European Personal Pension Product in line with EIOPA's advice.

Firstly, we want to stress that a successful PEPP should allow retail savers to make direct investments in shares of publicly traded companies. Investments in publicly traded property companies, including REITs, are well-suited to offer a safe and profitable investment opportunity because of their daily market pricing, low cost, liquidity, and long-term performance. They operate within a constitution that is transparent, accountable and well regulated. Therefore, it's important to design a PEPP which would offer such opportunities while promoting long-term investments.

Secondly, we refer to 'A Blueprint for Pensions: Saving enough, saving well, saving wisely' prepared by Insurance Europe in February 2017. This document clearly demonstrates that future adequacy depends not only on how much individuals save and how early they start saving, but also on their asset mix. Investing in a right range of assets can be as important as saving enough because of the very different long-term returns and diversification that are offered by the different asset classes.

We fully agree that it is important to set investment objectives of PEPPs right, including its much-needed default investment option to protect European savers while enabling them to receive high enough returns. Below, we'll be explaining why listed real estate should be identified as a 'must-have' asset classes in a diversified default investment option.

When managed correctly, real estate can offer a stable source of income and capital appreciation to investors, outperforming inflation over the long-term. When compared to other asset classes, real estate appears to be able to provide higher income returns as well as capital returns. When compared to other real estate investment vehicles, listed real estate companies have demonstrated better performance as well. Companies in the FTSE EPRA/NAREIT Developed Europe Index have yielded a dividend on average of 3.71% over the past five years. The index has consistently demonstrated a strong long-term performance - the annualized 20-year total return for the Developed Europe Index stands at 9.16% (as at December 2016).

Below we list a few examples of the asset allocation demonstrated by research to generate greater returns.

Case in Germany

Research in the German market also found that by lending a 30% global listed portfolio with a 70% allocation to Spezialfonds (the preferred real estate vehicle for German pension funds), the real estate allocation returns increased from 2.9% to 5.4%. And when compared to a 100% Bond portfolio, the multi-asset portfolio generated not only greater returns, but also lower volatility and therefore a higher Sharpe Ratio.

Case in the United Kingdom

A 2014 research paper by Moss and Farrelly showed the benefits of the blended approach as it applied to UK defined contribution pension schemes (NEST - National Employment Saving Trust). NEST allocated 20% to real estate out of which 30% in global listed real estate (REITs) and 70% to UK non-listed funds. This approach was chosen to enable efficient diversification by sector and geography and delivered an annualized total return of 7.5%, outperforming portfolios with no real estate stocks by ca. 1%.

F. Facilitating cross-border investment

Are there additional actions that can contribute to fostering long-term, infrastructure and sustainable investment? Are there additional actions that can contribute to facilitating cross-border investment?

DIVIDENDS DISTRIBUTED ACROSS BORDERS TO PORTFOLIO AND INDIVIDUAL INVESTORS

The emergence of listed property companies, including REITs, as successful means of facilitating capital flows into the business of owning and operating real estate for a long-run, reflects unique characteristics of real estate as a crucial factor in an economy's productivity. In addition, the stock exchange listing makes them accessible to all types of shareholders – from the largest insurance companies, through smallest pension funds to an individual saver. All this explains why governments are continuously adopting the REIT model all over the world, including in 13 member states in the EU.

Collectively, the European REIT sector is at a relatively early stage of its developments in comparison to other major global regions. The inefficiencies that restrict cross-border flows of capital into and amongst the European property sector is one of the key factors limiting the European REIT sector's effectiveness in competing with other major global regions.

For REITs, there are two cross-border flows of dividends:

i) Dividends distributed by the REIT to its shareholders (investors);

ii) Dividends distributed by a REIT-subsidiary to the REIT.

An accepted feature of the 'pass-through' tax transparent status means that REITs remove double taxation which otherwise applies to property investment via corporate vehicles – i.e. taxation of profits at company and shareholder levels. REITs profits are therefore taxed at the shareholders' level. However, when it comes to cross-border investments the 'pass-through' principle fails to function in many cases so that instead of one level of taxation, double taxation re-occurs. The main reason for the double taxation is often a relatively high withholding tax rate in the source combined with an imperfect tax credit in the state of residence of the shareholder (investor). This makes it more difficult for REITs to offer shares or participations to investors in other EU Member States, especially comparing with other collective investment vehicles such as real estate investment funds. <u>Such discrimination in the levying and crediting of withholding taxes on dividend payments to non-resident portfolio or individual investors restricts free movement of capital</u>.

WHAT NEEDS TO BE DONE AT EU LEVEL?

We commend PensionsEurope's efforts on the withholding tax procedures and refer to their position from April 2016 in which PensionsEurope provided several examples of the lack of reciprocal recognition of pension funds and problems with withholding tax (WHT) refund processes.[1]

Our members experience similar obstacles. In fact, such discriminatory treatment of pension funds restrict them significantly in making real estate investments. We agree with PensionsEurope recommendations[2] and join them in calling the Commission to assess feasibility of a European Directive which would facilitate the process by establishing quick and standardised WHT refund procedures.

In particular, we would like to explicitly refer to PensionsEurope's proposals on the Code of Conduct for WHT which we believe should apply to at least pension funds across Europe:

- To introduce relief at source as the method to levy the appropriate WHT from recognised pension funds within the EU;
- To introduce in all Member States the same and simplified evidence requirements to substantiate tax reclaims by recognised pension funds within the EU;
- Process submitted tax reclaims in a reasonable time frame (max. 3 months).

In this context, EPRA has additional recommendations while aiming at achieving a right balance between helping to address existing cross-border obstacles to truly competitive EU REITs, and protecting national interests such as safeguarding domestic tax bases. We believe this can be achieved by:

- Supporting the emergence of REIT regimes around Europe and working with Member States to encourage convergence of REIT rules to ensure that a coherent and consistent European listed property sector can be developed and deepen over time;
- Ensuring that the tax efficient pass-through of REITs earnings from rental activities is maintained while avoiding tax leakage as much as possible;
- Encouraging Member States to respect the 'pass-through' principle for REIT investments in cross-border situations, by acknowledging each other's REIT regimes through a process of mutual recognition.
    - There should be a set of minimum criteria for a REIT regime to qualify for mutual recognition, either prior to implementation, or as part of the Mutual Recognition process.
    - We would propose that the OECD definition of a REIT is recognised for this purpose.

[1] See PensionsEurope Position Paper on the withholding tax refund barriers to cross-border investment in the EU.
[2] See PensionsEurope Position Paper on the EC's Code of Conduct for relief-at-source from the withholding tax procedures.

About EPRA

EPRA is the voice of the European publicly traded real estate sector: it is a representative association for commercial property companies that are quoted on the public stock exchanges of Europe and other exchanges around the world. With more than 220 members, EPRA represents over €365bn of real estate assets and 93% of the market capitalization of the FTSE EPRA/NAREIT Europe Index.

EPRA's membership also includes the institutional investors such as pension funds and insurance companies that invest in or have an interest in investing in real estate indirectly via these listed property companies. Through the provision of better information to investors, improvement of the general operating environment, diffusion of best practices and the cohesion and strengthening of the industry, EPRA works to encourage greater investment in listed real estate companies in Europe with long-term and stable income producing assets.

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