IPD Consultation Response
OICU-IOSCO

11 February 2013

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Contents

Introduction

IPD's responses to this consultation are detailed below. In drafting these, we have endeavored to address the majority of questions asked, but unashamedly from a real estate investment measurement perspective since this is our only sphere of experience in the much bigger world of indices and benchmarks. Though IPD is now part of the larger MSCI Group, the IPD team continues to deliver specialist indices and benchmarks restricted to the property sector, and in what follows we draw only upon this sector specific knowledge base.

Real estate investment markets typically exhibit a unique combination of heterogeneity, lumpiness, illiquidity and complexity of ownership, leasing and occupation structures. Together these factors generate some exceptional challenges in the production and governance of performance indices and benchmarks.

IPD has responded to these challenges over 28 years by developing a self-financing blend of benchmarking and performance/risk analytics with market index computation and publication. The blend has been designed to offer the standardised and transparent measurement and governance expected of any major institutional investment asset class whilst at the same time ensuring that the indices and benchmarks remain richly relevant to the industry which has to come to terms with the uniqueness of that asset.

Any extension of the governance of index and benchmark compilation, production and publication must remain sensitive to the information and service requirements of a unique investment sector without undermining the logic of independent accreditation. In other words, anything which goes beyond industry driven voluntary self-regulation, configured as a partnership between an independent measurement organization and a broadly representative industry advisory body, will risk incurring much increased costs, delays and possibly perverse unintended consequences.

The major arguments for this form of industry self-regulatory framework for real estate indices and benchmarks appear to us as follows:

1. The total value of conventional financial instruments (swaps, futures, ETFs etc) linked to property indices - relative to the value of the directly traded investment market - remains very small indeed (just over 1%).
2. The structure of property investment indices and benchmarks required to support directly traded investment is such that their compilation is spread across a colossal number of asset and portfolio level data points, making manipulation extremely hard to do and easy for an independent measurer to spot.
3. This market configuration thus requires the provision of indices and benchmarks by a highly specialist independent agency which meets the significant costs of measurement through strictly non-advisory service provision and ensures full and appropriate benchmark governance through voluntary industry collaboration.

If we have been unclear in any of our answers or have not covered points upon which you would value our views, please contact any one of the drafting team listed below.

We have included copies of the IPD Protocol and our latest Index and Benchmark Guides to pre-empt perhaps some questions relating to the specifics of real estate performance measurement. The internal team responsible for drafting this response comprised:

Dr Ian Cullen, IPD Advisory Director

Mark Clacy-Jones, IPD Head of Indices

Glen Corney, IPD Head of Lender Services

Nazma Kurimbokus, IPD Head of Business Assurance

Davide Manstretta, IPD Head of Performance and Risk Analytics

Chapter 1

Scope

1. **Do you agree with the scope of the report and intended audience? Are there other Benchmarks or stakeholders that have idiosyncrasies that should place them outside of the scope of the report? Please describe each Benchmark or stakeholder and the idiosyncrasies that you identify and the reasons why in your view the Benchmark or stakeholder should be placed outside of the scope of the report.**

   The scope of the report is broad, but appears sensibly defined. Real estate indices and benchmarks are presumably subsumed within the “Alternative investments performance indices” category in Annex B, within which they represent by far the largest of this varied set of asset classes (around 57% by value in 2011 – Towers Watson report, July 2012). Each of these has unique and idiosyncratic attributes, but to any extent that financial products are linked to these indices (as they are in the case of IPD real estate numbers) they should fall within the scope of the report.

Chapter 2

Benchmark design

2. Do you agree that the design of a Benchmark should clearly reflect the key characteristics of the underlying interest it seeks to measure?

Not all of the "characteristics" listed in Exhibit 2 as yet apply with equal force in real estate. Thus the size of the property derivatives market relative to that of the direct market is currently very small, and so size relativities are not (for the foreseeable future) a significant issue. Thus the only European property market which is currently traded through on or off exchange derivatives is the UK. All contracts (mostly OTC swaps and Eurex futures) are linked to IPD Indices, but the outstanding notional of both stands at less than £3bn, which amounts to just over 1% of our best estimate of the total size of the directly invested commercial real estate market in the UK (£2.6bn open interest at Dec 2012 against an estimated direct market size of £237bn at Dec 2011, source IPD Global Index 2011).

This may and probably will change. But we take the general point to be that benchmark design must first and foremost be sensitive to the specific character and profile of the market(s) it is intended to reflect. This proposition seems unarguable, and it is likely that for the long foreseeable future the direct professional real estate market will drive the shape and nature of investment indices and benchmarks.

Quality and integrity of methodologies

3. What measures should Administrators take to ensure the integrity of information used in Benchmarking-setting and that the data is bona fide? Please highlight any additional measures required where Benchmarks are survey based. Please also comment on each of the factors identified in the discussion on the 'vulnerability of data inputs' such as voluntary submission, discretion exercised by Administrators. Are these measures adequately reflected in the discussion of roles and responsibilities of the Administrator discussed in section E?

Real estate investment indices and benchmarks are most authoritatively built from the detailed financial records of each of the actual assets held in professionally managed portfolios. Data submitters are therefore normally the fund/asset managers and their independent valuers.

Administrators and calculation agents (usually one and the same organization in real estate measurement) thereby have a huge responsibility for ensuring input data integrity.

It may be unique to real estate (though this seems unlikely) but with such a complex asset class which is still directly held within many thousands of investment portfolios worldwide, by far the most important control to manage is that upon the underlying data.

So just as it is crucial for all contributors to work to a single data template and a single set of content rules so that the targets of consistency, completeness and thus benchmark fairness are achievable, so it is also essential for the benchmark administrator - in partnership with index users - to design, distribute, maintain and review this template and related set of content rules so that these crucial targets can actually be delivered.

Within real estate performance measurement IPD has introduced the practice of independent but internally resourced auditing both of the data supplied by contributors and of the IPD processes of benchmark administration, computation and publication.

This has proved very effective since it is based upon high levels of relevant knowledge, is cost effective and can be managed through reporting lines and governance rules to achieve the highest standards of independence. However in the past it has been deemed appropriate from time to time to seek external validation of this process and commission an external audit from a major accounting firm of the full IPD data capture and reporting process.

4. **What measures should Submitters implement to ensure the integrity of information provided to Administrators? Are these measures adequately reflected in the discussion of a code of conduct for Submitters discussed in section E? In particular, should Submitters submit all input data and not a selection of such data so as to maximise the representation of the underlying market? Please comment on any practical issues that compliance with such an approach may give rise to.**

The code of conduct outlined in section E includes important and prudent guidelines for the governance of data submission, and IPD's documentation for data contributors in the property investment sector already covers many of these points.

However they are mostly procedural in nature, and whilst useful conditions for a disciplined benchmark assembly regime, they miss the central point in the assembly of real estate investment benchmarks. This is that all contributors must work to a single data template and a single set of content rules so that the all important targets of consistency, completeness and thus benchmark fairness are readily achievable.

To exemplify within the real estate investment sector, data contributors must report, asset by asset and for each measurement period, every single property (retained, bought, sold, refurbished, under development, shared, part sold, part purchased…) in accordance with a globally defined data template.

The most important principles which underpin this rule structure are enshrined in IPD's Protocol. This is effectively the code of conduct which is both shared between and managed by IPD - as the independent measurer - and the real estate investment industry - as both the source of the data and the main benchmark user. This is available to all on IPD's website (and appended to this response).

Transparency of benchmark methodologies

5. **What level of granularity with regard to the transparency of Methodologies would enable users to assess the credibility, representativeness, relevance and suitability of a Benchmark on an on-going basis and its limitations with respect to their intended use? Relevant factors could include; criteria and procedures used to develop the Methodology, type of data used, how data is collected, relative weighting of data used, how and when judgement is used, contingency measures (e.g., methods when transaction data is unavailable etc), publication of information supporting each Benchmark determination, etc. Please provide examples where you consider there are currently significant gaps in the provision of this information.**

All IPD market indices and performance benchmarks are carefully documented to all relevant users within the real estate investment sector, and, with respect to their use as the bases of synthetic products provided by third parties, are covered by further documentation on such matters as contingency measures.

Within this sector however it is not possible for index or benchmark users to recreate the products even given the fullest of documentation since the underlying asset level data is held by IPD (as the administrator and calculation agent) on a strictly confidential basis. This also means that methodological transparency does not lead to a risk of manipulation. Stringent concentration tests are applied, and so manipulation would require a colossal scale of malicious intervention across hundreds if not thousands of assets – which would be immediately spotted in IPD's exhaustive validation tests.

Transparency of contingency provisions for episodes of market disruption, illiquidity or other issues

6. **What steps should an Administrator take to disclose to Market Participants and other stakeholders the contingency measures it intends to use in conditions of market disruption, illiquidity or other stresses?**

Contingency measures have only limited relevance within the real estate investment sector, since the databases from which benchmarks are drawn can do no more than truly reflect the actual underlying direct asset market processes. Thus in extreme recessionary circumstances smaller property investment markets tend towards extreme illiquidity which means severe scarcity of transaction data and thin support in terms of evidence for the independent professional firms who are required to provide open market asset level assessments of value for (amongst many purpose) IPD databases.

The only option is to maintain high levels of vigilance and transparency so that all users understand what lies behind benchmark results at all times. There are no alternative data sources which can be used in emergencies.

Other more localised contingencies – for example disaster recovery plans for index/benchmark computation – are fully documented, discussed with oversight groups representing the industry, and available to users on request.

Transparency over changes to the methodology

7. What steps should an Administrator take to notify Market Participants of material changes to a Benchmark Methodology (including to Benchmark components) and to take their feedback into account?

The convention agreed between IPD and its Index and Benchmarking consultative groups, is that all method, composition or classification changes should be discussed well in advance in the relevant one or more of these formally constituted industry advisory groups. It should then be notified to all users through the formally agreed medium – the IPD open access website prior to the release of any results reflecting any of these changes.

A predefined notice period is not always possible as some of the composition changes may be reactions to external circumstances such as a last minute data submission failure due to force majeure.

8. How often should the Administrator review the design and definition of the Benchmark to ensure that it remains representative?

A regular regime of formal design and composition review – in the case of IPD indices and benchmarks between once and twice a year – is essential. But, as noted above, circumstances may occasionally require one-off decisions in addition to this regime.

Governance

9. The Consultation Report discusses a number of potential conflicts of interest that may arise at the level of the Submitters, between Submitters at different entities, and between Submitters, Administrators and other third parties. Are there other types of conflicts of interest that have not been mentioned that you consider may arise? If so, how best should these conflicts of interest be addressed? Are the measures discussed in the Consultation Report sufficient to address potential conflicts of interests at the level of the Submitters, between Submitters at different entities, and between Submitters, Administrators and other third parties?

Sections B and C articulate several useful ways of mitigating the risk of a conflict of interests involving data contributors. However our experience within the real estate sector has been that such risk is most effectively minimised by focusing on the data specification itself: as discretion over data content is reduced/eliminated; when all items of this content are rule governed; as the level of detail required is increased (and the process of transfer automated); and where the requirements of the data template are restricted to factual information.

None of this eliminates the need for an oversight body. Such a group can be powerful, in part as a second line of defence, but more crucially as the industry support for the introduction of change and a flexible response to ever changing market circumstances.

10. Do you agree that the Administrator should establish an oversight committee or other body to provide independent scrutiny of all relevant activities and management of conflicts of interest? Please comment if and why any different approaches might be appropriate for different kinds of Benchmarks. What is the minimum level of independent representation this committee or body should include?

An advisory body, reflecting all the major interests in, contributors to and users of the indices and benchmarks, can therefore add great value to the whole benchmarking process. A voluntary and advisory infrastructure can actually serve to strengthen the overall traction of a rule governed framework since it emphasises the essential partnership between all parties involved in the project and thereby invests the broadest based property industry support in the governance process. As noted, this can as often be a beneficial force for change and development as it is for the continued application of rule governed disciplines.

Accountability

11. Should the Submitters establish accountability procedures to assess their compliance with operational standards and scrutiny of Benchmark submissions?

12. Are the measures discussed in the Consultation Report (e.g. Audit Trail, external audits and requirement for regulatory cooperation) sufficient to ensure the accountability of Submitters? Should additional mechanisms be considered?

13. How frequently should Submitters be subject to audits? Should these be internal or external audits?

11-13. Typically within real estate benchmarking the numbers of separate data contributors will be large, as will the volumes and complexity of their data submissions. In these circumstances the data auditing regime developed by IPD, described above, involves highly trained staff working in an independently structured quality control team within the business.

They select small samples of contributors randomly each year with whom they then do a full post-hoc audit of their most recent data supply. The results of this exercise are then shared with an industry advisory body (without naming names) and this independently chaired group then publishes a summary report for the benefit of all users.

Accountability of the administrator

14. Are the measures discussed in the Consultation Report (e.g., complaints process, Audit Trail, external audits and requirement for regulatory cooperation) sufficient to ensure accountability of the Administrator? Should additional mechanisms be considered?

15. If recommended, how frequently should Administrators be subject to audits? Should these be internal or external audits?

16. Is public self-certification of compliance with industry standards or an industry code another useful measure to support accountability? This approach might also contemplate explanation of why compliance may not have occurred. If so, what self-certification requirements would make this approach most reliable and useful to support market integrity?

14-16. For the data volume and process complexity reasons noted above, internal but independently governed and reported scrutiny of real estate benchmark administration, calculation and publication is by far the most powerful approach. The same quality control team is used for internal process audits as for external data supply checks discussed above.

It is however crucially important that this monitoring should be industry supported (utilising the same voluntary advisory group structure) and transparently reported back to that industry and all other benchmark users.

End-to-end procedural scrutiny is effectively a continuous process of independent internal monitoring and quality control, but one which is itself occasionally submitted to the external scrutiny of a major accounting firm, also as noted earlier in this response.

Code of conduct for submitters

17. The Consultation Report discusses elements of a code of conduct for Submitters. Are the measures discussed (e.g., adequate policies to verify submissions, record management policies that allow the Submitter to evidence how a particular submission was given, etc.) sufficient to address potential conflicts of interest identified or do you believe that other control framework principles should be added?

18. What would be the key differences in the code of conduct for Benchmarks based on different input types, for example transactions, committed quotes and/or expert judgement?

17-18. A code of conduct for real estate investment data supply, necessarily including a comprehensive data template plus definitions and metadata rules, has for many years been central to a clear and authoritative index and benchmarking regime. The key differences in the code of conduct required for Benchmarks based on the performance of property investment portfolios mostly relate to the scale and granularity of the requisite data, which entails a very detailed “reference manual” style of data submission code.

Chapter 3

Approaches to enhanced oversight

19. **What are the advantages and disadvantages of making Benchmark submissions a regulated activity?**

20. **What are the advantages and disadvantages of making Benchmark Administration a regulated activity?**

21. **Do you agree with the factors identified for drawing regulatory distinctions? What other factors should be considered in determining the appropriate degree of oversight of Benchmark activities (discussed in Chapter 3)? Please provide specific recommendations as to how the distinctions discussed in Chapter 3 should inform oversight mechanisms.**

22. **What distinctions, if any, should be made with regard to Benchmarks created by third parties and those created by regulated exchanges?**

23. **Assuming that some form of enhanced regulatory oversight will be applied to an asset class Benchmark, should such enhanced oversight be applied to the Submitters of data as well as the Administrator?**

24. **What are the considerations that should be taken into account if the Submitters to a Benchmark operate in an otherwise unregulated market (e.g., physical oil, gold or agricultural commodity markets) and are not otherwise under any obligation to submit data to an Administrator?**

25. **Do you believe that a code of conduct, either on its own or in conjunction with other measures outlined within the report, would provide sufficient oversight to mitigate the risks that have been identified in Chapter 2? What measures should be established in conjunction with a code of conduct? For which Benchmarks is this approach suitable?**

26. **What other measures outlined in the report, if any, should apply in addition to a code of conduct? If you believe a code of conduct, either on its own or in conjunction with other measures outlined within the report, would provide sufficient oversight to mitigate the risks that have been identified in Chapter 2, what type of code of conduct should apply (e.g., a voluntary code of conduct, an industry code of conduct submitted to and approved by the relevant Regulatory Authority, a code of conduct developed by IOSCO, etc.)?**

27. **Do you believe that the creation of a Self-Regulatory Organisation (.e.g., one that exercises delegated governmental powers) and itself subject to governmental oversight, whether or not in conjunction with industry codes is a viable alternative for sufficient oversight and enforcement to mitigate the risks that have been identified in Chapter 2? For which Benchmarks is this approach suitable? What if any complementary arrangements might be necessary, such as new statutory obligations or offences for Administrators and/or Submitters?**

28. **Do you believe that, for some Benchmarks, reliance upon the power of securities and derivatives regulators to evaluate products that reference a Benchmark or exercise their market abuse or false reporting powers creates sufficient incentives for the Administrator to ensure sure that Submitters comply with a code of conduct?**

29. **Do you believe that users of a Benchmark, specifically, the users who are regulated or under the supervision of a national competent authority should have a role in enhancing the quality of Benchmarks? Which form should this role take: on a voluntary basis (e.g. the user being issued a statement that will only use Benchmarks that follow IOSCO principles), or on a compulsory basis (e.g., the competent authority could request that users who are registered under their jurisdiction should only use Benchmarks that fulfil IOSCO principles)?**

19-29. The formal regulation of real estate benchmarks - their data sourcing, administration, calculation and publication - would almost certainly do nothing but slow down the operation of the underlying property market and increase its costs of operation significantly without improving its benchmark disciplines or transparency. This is because the processes of measurement and benchmarking, if they are to be relevant and accurate, must be closely integrated with those of property fund management whilst being provided by a completely independent agency.

A voluntary code of conduct which encompasses the content and supply of real estate investment data, the management of all requisite databases, and the governance of benchmark aggregation, computation and reporting, is therefore the only practical way forward. Moreover this code of conduct should be a responsibility which is shared between the independent measurement agency and the investment marketplace which is the object of that measurement as well as the source of the data – the portfolio owners, managers and other index users.

It should also be placed firmly into the public domain. The IPD Protocol, attached to this response, fulfils this function for real estate investment benchmarking and was produced through a process of industry collaboration. The voluntary participation of all users in the development and application of this code of conduct is key to the medium term enhancement of the overall benchmarking process.

Chapter 4

Data sufficiency

30. Do you agree that a Benchmark should be anchored by observable transactions entered into at arm's length between buyers and sellers in order for it to function as a credible indicator of prices, rates or index values? How should Benchmarks that are otherwise anchored by bona-fide transactions deal with periods of illiquidity due to market stress or long-term disruption?

31. Are there specific Benchmarks for which you consider that observable transactional data is not an appropriate criterion or the sole criterion? If so, please provide a description of such Benchmarks and what value you think such Benchmarks provide?

32. What do you consider the limitations or value in Benchmarks referencing asset classes and underlying interests where there is limited liquidity? Please describe the uses and value of such Benchmarks in the financial markets.

33. Do you agree that the greatest weight should be given to transactions in the construction of a Benchmark and that non-transactional information should be used as an adjunct (e.g., as a supplement) to transactions?

34. What factors and how often should Administrators (or others) consider in determining whether the market for a current Benchmark's underlying interest is no longer sufficiently robust? What effective methods of review could aid in determining the insufficiency of trading activity within the market for a Benchmark's underlying interest?

30-34. The overriding rule for benchmark design and validation is that it should reflect the market it aims to report as closely and comprehensively as possible. This rule becomes more challenging as the complexity of the market increases and where the benchmark relies upon voluntary participation by investors.

Real estate indices and benchmarks have always had to face both of these challenges. The complexity of the market flows from the nature of the assets – large, heterogeneous, management intensive and illiquid. In these circumstances all mature markets have put in place an open market valuation regime to provide a regular estimate of the spot price for each untraded asset held in each professionally managed portfolio. Whenever an asset is traded, records of both gross and net achieved prices are available.

The benchmarking regime that IPD has developed for this market over close to 30 years has not therefore assigned arbitrary higher or lower priorities to transactions or valuations, but has always utilized both. Thus both capital and total return benchmarks are computed by aggregating across all assets in all relevant portfolios in such a way that the full investment contribution of each asset is completely and accurately included – from the gross price of its acquisition through its valuation and active management history (capital and revenue account flows) to the net proceeds of its eventual sale.

There will be circumstances in which benchmarks are or become non-viable, and these may reflect an extreme reduction in liquidity that thereby provides inadequate evidence for the professional valuation process to continue. Such a circumstance has never arisen in the IPD history of market tracking, but it has been a risk which has been widely acknowledged. Non-viability of benchmarks has in practice been much more associated with the second of the real estate sector challenges noted above – that of the voluntary framework of participation. This has meant threshold market coverage and portfolio concentration tests have been essential since the inception of the IPD service.

Transition

35. What precautions by Benchmark Administrators, Submitters, and users can aid Benchmark resiliency during periods of market stress, mitigating the potential need for market transition?

36. What elements of a Benchmark "living will," drafted by a Benchmark Administrator, should be prioritised?

37. By what process, and in consultation with what bodies, should alternatives be determined for Benchmark replacement?

38. What characteristics should be considered when determining an appropriate alternate Benchmark? (Examples below) Should any of these factors be prioritised?

- Level and Type of Market Activity
- Diversity/Number of Benchmark Submitters
- Length of historical price series for the Benchmark alternative
- Benchmark Methodology
- Existing regulatory oversight
- Existing enforcement authority
- Volume, tenors and contract structure of the legacy trades

39. What conditions are necessary to ensure a smooth transition between market Benchmarks?

40. What considerations should be made for legacy contracts which reference a Benchmark in transition? To what extent does a substantive legacy book preclude transition away from a Benchmark? What provisions can be included in [new and existing] contract specifications which would mitigate concerns if and when a Benchmark transitions occurs?

41. **How should a timeframe be determined for market movement between a Benchmark and its replacement? What considerations should be made for:**
    - Altered regulatory oversight?
    - Infrastructure development/modification?
    - Revisions to currently established contracts referencing the previous Benchmark?
    - Revisions to the Benchmark Administrator?
    - Risk to contract frustration

35-41. Some of the major challenges facing real estate benchmarking have been noted above. Mitigating the risks flowing from these challenges is clearly the route to avoiding the necessity of replacing the current with a new benchmarking regime. The upheaval would be enormous because the uses of the current range of IPD property indices and benchmarks are hugely diverse and the numbers of users run into many hundreds of thousands.

This fact is probably the strongest guarantee of their long term resilience. The indices and benchmarks are robust because they are firmly rooted in the complex mix of property investment sector practices and procedures. The use of a correct blend of **all** transaction and **all** valuation evidence means that periods of market stress and dislocation can be weathered as they have over the past 6 years. The insistence upon tracking all performance down to the level of the individual asset means that far more validation is possible and the risk of major errors is minimised. And the meticulous governance of that highly detailed process of asset level tracking means that the scope for manipulation is radically reduced.

The questions about benchmark transition procedures therefore appear inappropriate in the case of real estate investment measurement. This is not a complacent response. There does not appear to be any "quick fix" alternative to the current result of an evolutionary process. Moreover the evolution should never be regarded as in any sense "completed". Real estate index and benchmark design, construction and management can and should go on developing through the voluntary partnership between the industry and its independent measurers.