



[By electronic submission and by post]

Fiona Campbell
Prudential Policy Division
Financial Services Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

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Dear Fiona,

Commercial Real Estate Finance Council Europe comments on FSA CP 11/9 – securitisation section

We welcome the opportunity to provide comments on the FSA Consultation Paper 11/9 (*CP11/9*) entitled Strengthening Capital Standards 3 – further consultation on CRD3. This response addresses the interpretation of the terms “securitisation” and “re-securitisation” referred to in Chapter 3 of CP11/9 in the context of commercial real estate finance transactions.

CRE Finance Council Europe was formed in July 2004 and is part of the CRE Finance Council (CRE Finance Council®), an international trade association dedicated to promoting the ongoing strength, liquidity and viability of commercial real estate capital market finance worldwide.

With over 60 member companies in Europe, CRE Finance Council Europe offers unparalleled leadership in the commercial real estate capital finance markets. As a global trade association, our diverse membership represents the full range of the industry’s market participants, from senior executives at the largest money-centre banks and investment banks, rating agencies, insurance companies and investors to service providers.

We have read the comment letter in respect of the parts of CP11/9 which deal with securitisation including implementation of CEBS Guidelines to CRD2 Article 122a (the **CEBS Guidelines**) and trading book capital charges directed to you by the Association for Financial Markets in Europe / European Securitisation Forum (AFME / ESF), the British Bankers' Association (BBA) and the Futures and Options Association (FOA), and would like to emphasise that, in addition to the comments made herein, we fully support the comments made in that letter.

Unless otherwise specified, each reference to a numbered paragraph refers to a paragraph of CP11/9.

Responses to consultation questions

Q6: Do you agree with our proposed approach to implementing the CRD3 re-securitisation changes?

Application of the term “securitisation” to commercial real estate finance

We note your statement in chapter 3.13 that: “*Respondents expressed concerns that, in our implementation of a new definition of re-securitisation, we would look to reassess our views on the scope of exposures captured by the CRD definition of securitisation. Commercial Real Estate AB loan structures were highlighted in this regard. It is not our intention to classify exposures in a manner that is inconsistent with the CRD definition of securitisation, and we are not amending the definition of securitisation in the Glossary. But firms should consider the economic substance, not just the legal form, of each exposure to determine whether it is a securitisation or a re-securitisation position.*”

AB loan structures are of great importance to the commercial real estate finance industry and it is crucial that their treatment for regulatory capital purposes is clarified. This uncertainty is preventing the execution of new transactions which would bring much needed finance to the real economy and allow financial institutions (including those regulated by the FSA) to refinance their indebtedness. Such structures developed separately from securitisation. However, the definition of “securitisation” applied in BIPRU could be interpreted to include AB loan structures. We are encouraged by your indication that firms should consider economic substance and not just the legal form when determining whether a transaction is a “securitisation” and should be grateful if you would confirm that the lenders under an AB loan structure having the following characteristics would not be treated as having a securitisation exposure:

- (a) an entity which is the legal owner of one or more commercial real estate assets (the ***Borrower***) is funded directly by a single whole loan that is subsequently bifurcated into two loan participations (A and B) by means of the loan transfer mechanics contained in the loan agreement entered into with the Borrower;
- (b) the lenders of the two loan participations under the loan agreement enter into an intercreditor agreement pursuant to which the claim of the lenders under one loan (the ***B Loan***) are subordinated in certain circumstances to the claims of the lenders under the other loan (the ***A Loan*** and together with the B Loan, the ***Loans***). Although the Borrower is not party to the intercreditor agreement, the lenders of both Loans remain lenders of record and participants in the single whole loan made to the Borrower;
- (c) unless a material event of default under the loan agreement occurs, the A and B Loans remain pari passu, albeit technically payments are made sequentially to the A and B lenders (the sequential nature of the payments being irrelevant in the absence of a material event of default). Upon the occurrence of a material event of default or upon enforcement, the sequential payment structure will direct cashflow to the A Loan at the expense of the B Loan;
- (d) the B lender remains directly involved in the administration of the loans via certain entrenched rights in respect of specific amendments, waivers or consents to be granted under the loan agreement, although the B lender will have only limited rights

in respect of any proposed enforcement of the security package provided by the Borrower and affiliates; and

- (e) Both the A and B lenders remain “Finance Parties” for the purposes of the finance documents (including the loan agreement) to which the Borrower is party. As a result, both lenders are beneficiaries of the security package provided by the Borrower, albeit with the A Loan ranking ahead of the B Loan in the enforcement proceeds waterfall contained in the intercreditor agreement.

We would argue that the Loans would not constitute securitisation exposures for the following reasons:

- (a) there is no “re-packaging” of loans, therefore, the economic substance of the Loans does not conform to the economic substance of a securitisation as implied by recital (24) of Directive 2009/111 i.e. *“It is important that the misalignment between the interest of firms that ‘re-package’ loans into tradable securities and other financial instruments (originators or sponsors) and firms that invest in these securities or instruments (investors) be removed”*;
- (b) this distinction is further emphasised by the fact that the lenders in respect of the Loans are clearly the “originator” as that term is defined in the Glossary and no third party which is taking credit risk is involved in the transaction. The direct, contractual nexus between the Borrower and the lenders of both Loans is not affected in any way by the lenders’ decision to regulate their respective rights against the Borrower and each other under the intercreditor agreement. It is, therefore, not apparent how there can be a “securitisation” where all of the credit risk is borne by and all of the funding is provided by the “originators”. The AB loan structure described above is a further step removed from the situation described in paragraph 22 of the CEBS Guidelines to Article 122a where funding is provided by third parties but the credit risk remains with the originator(s) because both credit risk and funding remain with the originators (i.e. *“This definition captures the tranching of credit risk, rather than specifying the need for the transfer of credit risk vis-à-vis third parties. Therefore, where such tranching of credit risk occurs and the definition is met, the requirements of Article 122a would apply. Nevertheless, when the tranching of credit risk is made on the liabilities issued by an originator or multiple originators (including, for instance, covered bonds), and such liabilities do not transfer the credit risk of third parties, because the credit risk clearly remains with the originator (the originator is the final debtor to the investor), it is clear that economic interests are already aligned and thus the requirement for retention under Paragraph 1 may be deemed to be fulfilled automatically.”*) By comparison to the requirements of Article 122a of the Capital Requirements Directive, it is not possible for the “originators” (i.e. the lenders of the A Loan or B Loan) to retain credit risk in such loans at the point of origination as they are fully exposed to the credit risk of the asset which is being created through the origination process; and
- (c) if AB loan structures were to be caught by the definition of “securitisation” (on the basis that there is tranching by reason of the execution of an intercreditor/subordination agreement by the creditors), the definition would, by analogy, apply to all of the financial indebtedness of any entity where some of its

creditors had agreed that their indebtedness should be subordinated. This does not seem to be the desired result.

Application of the term “re-securitisation” to commercial real estate finance

We should be grateful if you would confirm that a commercial mortgage backed securitisation (**CMBS**) where one or more AB loans is securitised will not constitute “re-securitisation” exposures by reason of the inclusion of such loans in the relevant pool of securitised assets. In our view, this conclusion is warranted because:

- (a) such Loans should not be classified as securitisation exposures even though they are tranching (for the reasons described above); and
- (b) a CMBS of tranching loans is not analogous (in terms of economic and legal structure) to collateralised debt obligations of ABS which are the express target of the rules in relation to re-securitisations.

Based on data provided by Fitch Ratings¹, we estimate that there is currently EUR 32.4bn of CMBS containing one or more tranching real estate loans being held by European credit institutions and investment firms which are subject to the prudential rules set out in the Capital Requirements Directive. If these CMBS were treated as re-securitisations, we estimate that the capital which would have to be held against such assets would increase from EUR 6,976bn to EUR 7,388bn. This would directly reduce the ability of such institutions to lend to the real economy and have a drastic impact on the market value of such assets – neither of which is justified by the prudential risk they pose. This may or may not be a reason not to treat CMBS of tranching loans as “re-securitisations” but it does highlight the fact that this classification will have very real consequences for European financial institutions.

Conclusion

We are grateful for the opportunity to raise these issues with you and would be happy to discuss them further with you at your convenience. We would emphasise that the current uncertainty in relation to the points we raise above is preventing transactions being executed which would allow the refinancing of current indebtedness and/or provide new financing to corporates thereby reducing the requirements of some institutions for central bank funding and encouraging European recovery.

Yours sincerely,



Jaymon Jones

Director

On behalf of Commercial Real Estate Finance Council Europe

¹As of July 2011, €40.5bn outstanding note balances rated by Fitch Ratings which contain one or more A/B Loans within the pool and assuming that 80% of the notes are held by European credit institutions and investment firms which are subject to the prudential rules set out in the Capital Requirements Directive.