CREFC Europe

Response to the questionnaire from the European Banking Authority on the potential development of a "high quality" securitisation market in the EU

CREFC Europe is grateful for the opportunity to contribute to the EBA's consideration of the future of securitisation in Europe. We have set out some introductory remarks and key messages below, before providing our responses to the questionnaire. We have not been able to conduct as thorough an exercise as we would have liked (nor to coordinate with other responding organisations) because of the limited time that was available, but we hope that this response is helpful. Throughout, our focus is on the commercial real estate (**CRE**) sector and CMBS, rather than on the wider securitisation market.

Context

The CRE industry is responsible for very large part of our built environment, providing and maintaining the buildings in which we work, shop and relax (and, in the case of residential investment property, in which we live). Besides contributing to economic activity and employment directly, CRE 'enables' investment and economic activity across the economy, and supports the delivery of social infrastructure and the climate change agenda. Perhaps most importantly, a large and healthy CRE investment sector allows other businesses to rent the space they need according to their changing needs, and to focus their attention and their capital on what they are good at.

Property is a fundamentally long-term, illiquid and capital intensive asset class, and debt is an essential component of how it is financed. It is also a cyclical asset class, partly because of its illiquidity (values respond to changes in demand as supply is much slower), and partly because of the strong feedback loop that exists between property and credit cycles. In Europe, banks are not only the dominant originators of CRE debt – they are also the dominant holders of CRE debt.

Banks are very natural CRE debt originators, especially at smaller ticket sizes (below EUR50m, say) for which other potential lenders lack the requisite infrastructure. But it is not attractive for CRE debt to be highly concentrated in the banking system. CMBS is a good mechanism for banks to disperse some of the debt they originate across the financial system, giving other potential investors the opportunity to invest in it. By investing in CMBS for short term liquidity banks can also contribute liquidity and confidence to the secondary CRE debt market. That is particularly important when other potential investors are facing regulatory disincentives to invest in CMBS (for example, European insurers under Solvency II).

As well as causing systemic risk to build up in the banking system, the dominance of the banks as holders of CRE debt points to a market failure, insofar as the financial system is failing effectively to connect CRE businesses wanting to borrow with non-originating investment capital seeking CRE debt returns. A liquid secondary market in CRE debt – such as CMBS can help provide – would deliver a more stable, diversified CRE debt market, with benefits for financial system resilience, improved transparency and choice for non-originating investors, and more sustainable credit flow to the property sector itself.

It is important to note one more feature of CRE (and thus of CRE debt) which differentiates it from other securitisation asset classes. CRE is a highly heterogeneous asset class. Performance is highly asset specific, and the averages produced by CRE market indices even for quite small market segments can hide very broad variation among their constituents. Unlike other securitisation asset classes, which are more likely to involve large numbers of smaller, relatively homogeneous loans, CRE debt is not susceptible to statistical analysis. Finally, individual properties (and therefore CRE loans) can also be very large, and that means that risk diversification can be achieved very effectively at the tenant level; there is no need, in other words, for granular loan pools in order to avoid concentration risk in the CMBS context.

Key recommendations

Capital rules affecting CRE debt should seek:

- to be broadly aligned with economic risk, to respect the principle of capital neutrality, and to avoid creating unnecessary cliff-edges – save to the extent that there are powerful reasons for using capital rules to drive particular behaviours, and the potential consequences have been carefully considered from all angles; and

- to be counter-cyclical. Historically, regulators have been as guilty of pro-cyclical behaviour as lenders. Inappropriately loose regulation during a boom has rendered the financial system vulnerable to a crash; and after the crash, heavy-handed regulatory intervention has compounded risk-aversion among lenders to stifle the flow of credit to the economy when it is most needed.

When regulation fails to align with economic risk – or to correct cyclical markets' mispricing of economic risk – market behaviours are distorted in the financial system as both capital and financial intermediaries seek the path of least resistance to achieve their objectives. The result is likely to be that risk builds up in parts of the financial system that are harder to monitor or manage.

At a more detailed level:

- Any high quality securitisation (**HQS**) concept should seek to encourage simpler, more transparent securitisation structuring across all asset classes, including by applying lessons from the crisis to set appropriate standards. If such an approach were adopted, it would not be unreasonable to impose capital penalties on non-conforming securitisations, and one would expect most transactions to meet the standard and therefore (quite appropriately) to attract capital charges reflecting economic risk and respecting capital neutrality.

- A HQS concept designed instead to set a gold standard for very low risk securitisations – a sort of regulatory AAA+ 'rating' – feels problematic from both a policy and commercial perspective.

  - Would qualifying securitisations attract capital relief (as compared to economic risk and capital neutrality)? Or would non-qualifying securitisations attract a penalty? What proportion of the total market might attract capital treatment not reflective of economic risk and not respecting capital neutrality?

  - What behaviours would such an approach incentivise? Are the likely responses to a single, simple cliff-edge also intended and desirable? Would the HQS gold standard be theoretically achievable by any transaction? If not, what criteria would determine which asset classes, risk/return profiles, etc. could qualify, and which could not? What impact would the HQS criteria have on credit flows to different parts of the economy (on either side of the HQS boundary)?

  - What kind of HQS concept might address the desire to promote investment supporting the long-term financing of the European economy? Many important parts of the European economy requiring long-term finance are not low risk – so on the face of it a low risk gold standard HQS is unlikely to help; at best, the criteria would have to be based on a combination of risk-related and political considerations.

  - What is the strategic regulatory objective for non-HQS, and has it been considered from a broader financial stability and socio-economic policy perspective?

- In the CMBS context, relatively poor performance since the crisis has largely been the result of:
    - a lack of agreed eligibility criteria at the loan level (compare requirements for RMBS or for Germany's *Pfandbriefe*, for example) and a very fragmented market with huge informational challenges and little standardisation or widely accepted best practice; and
    - the fact that the product developed quickly, effectively during the course of a single CRE boom and bust cycle of extreme proportions by historical standards (with some poor underwriting and structural features in the frenzy of the boom, and a hard landing in the bust)
- A possible solution for better quality CMBS would be for the industry – probably acting through CREFC Europe and other interested representative bodies and potentially with the participation of interested regulators – to create best practice criteria for underlying CRE loans. That, coupled with regulatory encouragement for simpler and more transparent securitisation structures, might reduce the market's reliance on external ratings, and help build a stable secondary market in CRE debt. That in turn should help reduce the concentration of CRE debt risk in Europe's banking system.

We are delighted that regulators are recognising the potential for securitisation markets to play a valuable role in supporting investment in the long-term financing of Europe's economy. We would like regulators also to recognise the role that secondary debt markets could play in supporting the CRE sector, which is a vital enabling part of the real economy, needs long-term finance, and can threaten financial stability when lenders and regulators get it wrong.

Detailed responses to specific EBA questions

Current state of the securitisation market in the EU

1. Please provide an overview on the current state of play of securitisation in the European financial sector (outstanding, volume, issuance, types of issuances).

There is no universally accepted single definition of CMBS, and certain transactions may be classified as CMBS or as corporate debt, for example. Broadly, the total stock of CMBS in Europe is around EUR75bn to EUR80bn (out of a total European ABS market of around EUR685bn), down from EUR120bn in 2010 due to amortisation and limited new issuance. Existing issuance comprises around GBP40bn UK (GBP23bn fixed rate, GBP17bn floating rate) and EUR34bn continental European (EUR6bn German multifamily, EUR28bn other floating rate).

After a few very lean years, new issuance returned in 2013 with around EUR9bn, comprising German multifamily (48%), UK retail, student accommodation and telecoms infrastructure (42%), UK office (5%) and Italian retail (4%). Most of that issuance was sponsored by borrowers tapping the capital markets, rather than traditional conduit issuance by the banks. Uncertainty about the impact of various regulatory initiatives on investor demand may be affecting banks' willingness to underwrite CRE risk for securitisation.

2. Please provide an overview of the investor base for securitisation products.

Insurers, asset managers, hedge funds, pension funds and supra-national bodies and bank treasury departments. Both European and non-European. Some subscribe to hold, others (such as banks) are more active users of secondary market liquidity.

For some, such as large insurers, it is possible to gain broadly comparable risk and return through direct origination (lower liquidity, but greater control) – something that their own emerging regulatory framework seems to be encouraging them to do. For others, such as fixed income investment managers, CMBS is not easily replaced as part of a diversified portfolio, so the continued existence of a reasonably large, healthy and liquid CMBS market is important.

3. Following on from the previous question, securitisation products may be purchased by both banks, insurers, and certain other parties. Each of these investors may be exposed to different risks (credit risk, spread risk, etc.), depending on whether they are trading or holding to maturity. Can you provide evidence to support the relative split of activity in these types (for example, share of ABSs held to maturity, share of ABSs held for trading, split by banks, insurers, as well as other investor types)?

It is important to remember the context for CMBS, which is that in Europe this is an asset class still in its infancy, which has not yet developed into the broad, deep and varied product that CMBS is in the United States, where it has a longer history, real two-way liquidity, and better performance.

European CMBS are usually short, floating rate bonds which are not therefore very attractive to total return accounts looking to make money from spread tightening. While being more liquid than CRE loans, European CMBS are not as liquid as American CMBS or other European ABS. It is relatively common for new European CMBS issuance to go to 'buy to hold' investors.

Secondary market trading is predominantly conducted via circulation of 'bid lists' to bank dealing desks. One major investment bank saw bid lists totalling EUR4bn of European CMBS in 2013 and has so far seen EUR5.6bn in 2014 (of which an uncertain proportion will consist of repeat trading of the

same bond over the period). Those figures suggest that a high single digits percentage of the outstanding stock is trading each year – a satisfactory level of liquidity, indicating that investors who wish to trade in the secondary market are able to do so.

Impact of current and expected regulation on the revival of the EU securitisation market

4. Please specify all current and expected regulation in the EU and international that is impacting the revival of the securitisation market. Please specify why and how each specific regulation (CRR, Solvency II, EMIR, AIFMD, Basel, etc) of the regulation is impacting the recovery of the securitisation market.

The most important relevant regulation is Solvency II, which creates strong, distortive incentives for insurers to avoid CMBS and prefer other, often riskier exposures that get much better capital treatment. **Appendix 1** to this response is a joint submission by CREFC Europe and INREV to EIOPA in response to EIOPA's December 2013 technical report on standard formula design and calibration for certain long-term investments (EIOPA/13/513), which outlines our main concerns. See also the response to Q5 below. The key policy problem, under Solvency II and also under Basel, is that capital regimes that fail to reflect economic risk or to respect the principle of capital neutrality are almost certain to distort behaviours and capital flows and potentially to drive systemic risk build-up to areas of the financial system that may be outside regulators' field of vision.

In terms of other European regulations, assuming that the AIFMD and EMIR exemptions for securitisation SPVs work as expected, the main material problem seems to be the threat of cash margin requirements for non-centrally cleared derivatives. There are certain types of transaction for which the risk retention rules under CRR may cause problems, depending on how they are analysed (and there appears to be continuing uncertainty, and a lack of harmonisation across the EU, as to how they should be analysed). CRA3 also presents challenges for some deals, in particular by imposing a high degree of public disclosure on private transactions; however, even relatively less onerous additional disclosure requirements for public deals are of uncertain value, given far-reaching existing requirements.

Internationally, the potential impacts of Dodd Frank and the Volcker rule should not be underestimated, and concerns remain that the new Basel framework for securitisation exposures still imposes inappropriately high risk weights for banking book exposures and potentially trading book exposures as well.

5. Please illustrate the differences in regulatory treatment of loans, covered bonds and securitisation of the same asset type, and the consequences of such differences?

The most striking example is from Solvency II. A five year duration single A rated whole loan (or a covered bond underpinned by such loans) attracts less than 4% aggregate capital charge, whereas a five year duration AAA CMBS bond underpinned by such loans attracts an aggregate capital charge of 62.5%. Even an equity investment (for example in GAGFAH, a German residential landlord that has also issued multifamily backed CMBS) carries a charge of only 39%; even an equity investment in alternative investment funds carries a 49% charge. On a relative basis, it is difficult to see the charge for AAA CMBS as anything other than penal.

Regulators ignore economic risk and capital neutrality at their peril. Looking at insurers faced with the standard Solvency II model, the natural response to a 15x differential in capital cost is either to originate or to reduce portfolio diversification by excluding CRE debt. The latter route – which is more likely to be chosen by smaller institutions for which building a loan origination platform is too costly or difficult – serves no-one's interests. The former also has serious problems, however. While direct loans do offer greater control and visibility and the power to negotiate the lender's position:

a) they lack the liquidity of a listed bond product;

b) they may result in greater concentration of risk;

c) direct lending is likely to be limited to larger ticket sizes and larger urban centres – meaning that finance may be restricted to areas and businesses that already have a relatively diverse and resilient supply of credit, with worsening access to credit (and thus ability to invest) for smaller and regional borrowers. Risks associated with lending to such borrowers are likely to remain concentrated in the banking system (as banks with their local branch networks will continue to be able to advance smaller and regional CRE loans, and will find it harder to pass on their exposure to others). This might seem positively to discourage investment in the long-term financing of important parts of the European economy.

One further option for insurers seeking CRE debt risk/returns is to allocate funds to debt fund managers. That is an attractive development from the point of view of increasing the diversity of the CRE debt industry – but investments in funds do not generally match the liquidity and transparency (however imperfect) of CMBS.

6. Following on from the previous question, is it justifiable for whole loan portfolio to attract less regulatory capital than senior tranches of such portfolio securitisation – why or why not? Should the regulatory treatment of whole loan portfolios and of their securitisations be harmonised – why, how, consequences?

The starting point should be capital neutrality and alignment with actual economic risk – and that would normally point towards neutral or better treatment for senior securitised exposures as compared to the underlying loan portfolio. The fact that a particular ABS asset class may have performed poorly, especially through the last cycle (which was especially volatile in parts of the economy) does not alter the fact that bonds generally provide more transparency and greater liquidity than the underlying loans.

That is particularly the case with CRE, a heterogeneous asset class that does not lend itself to statistical analysis: CMBS is the only part of the CRE debt market which provides any meaningful transparency for market participants or for regulators. By punishing high price volatility or relatively poor performance during the last few years, regulators risk leaving more CRE debt (a) within the banking system, (b) without any near-term prospect of an effective secondary market providing two way liquidity, and (c) in the shadows, because of the very limited disclosure in the private CRE debt market and the lack of external research scrutiny or ratings. Regulators should not underestimate the value of external ratings and third party analysis possible for securitisation exposures but generally absent in a private underlying loan market.

It would be good to see the development of a secondary market in CRE loans. For that to happen, we will almost certainly need to see greater standardisation in CRE lending, and broader adoption of accepted best practice standards. Those developments would also benefit the CMBS market, by facilitating a consensus around eligibility criteria to emerge that has been missing in the past. A CMBS market working on that basis would (for reasons of disclosure, transparency, liquidity, etc.) be better than whole loans trading at efficiently connecting investment capital seeking CRE risk and returns with CRE borrowers in the real economy. CMBS will always be more liquid than loan books (the main liquidity advantage of the loan book owner is the ability to sell individual loans or sub-portfolios – but that is costly and slow compared to the ability to trade a bond).

Regulatory penalties for CMBS relative to underlying loans undermine the efforts of those trying to improve a product that has an important role to play in the market and for financial stability. At the very least, senior securitisation exposures should be treated no worse than the underlying portfolio

(which lacks the credit enhancement features from which senior securitisation bonds benefit).

Rationale for public authorities developing a 'high quality' securitisation product

7. How would you define a "high quality" and "low credit risk" securitisation product/tranche (without reference to external ratings)? Please provide historical performance evidence to justify your answer

We question the rejection of external ratings. The credit rating agencies are not immune to mistakes (no-one is), but regulatory steps since the crisis should reduce the systemic/structural causes of mistakes in the future. Furthermore, external ratings are relatively flexible, with periodic refinement of rating methodologies and the ability to make (and explain) changes to ratings, and they are subject to market scrutiny. Investors can choose how much reliance to place on them.

A HQS concept defined in capital rules would be both more influential and less flexible. It would also create a huge cliff-edge, making any meaningful alignment with economic risk or capital neutrality all but impossible for much of the market. It would distort capital flows and risk build-up in unintended ways that may be difficult to monitor or control. Its credibility could be vulnerable if the performance of qualifying HQS bonds failed to reflect market perception of the HQS brand.

We are also troubled by a lack of clarity about the purpose of the HQS concept. The question is what, exactly, the HQS concept is seeking to promote. It could be:

- investment to support the long-term financing of Europe's economy (which may of course involve investing in higher risk, higher yielding loans); or

- a securitisation market which – having regard to lessons learned through the crisis – is structurally sound, based on good information and transparency, whereby investors are able to analyse and assess risk and reach an informed view (which, again, could cover all parts of the risk spectrum); or

- very safe, low risk investment instruments – most probably by imposing a capital penalty (relative to underlying economic risk) on non-qualifying securitisation exposures, regardless of their value to the European economy or the quality of the structuring or transparency that characterises them?

We believe that if capital rules are to be used to encourage particular behaviours (as opposed to merely seeking to reflect economic risk), they should be used to encourage best practice in terms of the structural and transparency features of securitisations, having regard to lessons learned from the crisis. That would suggest a capital penalty for highly complex structures or where the quality or quantity of information available to investors is inadequate. Where securitisations meet the HQS standard, they avoid that penalty, and the capital charge simply reflects the regulatory assessment of actual economic risk (whether high or low). Equally, a complex or impenetrable securitisation would be penalised with an additional capital charge, regardless of whether the economic risk (absent the securitisation structure) is high or low.

If capital rules generally seek to reflect economic risk and to respect the principle of capital neutrality (as we believe they should), and we leave to one side the more 'political' aspect of the long-term financing agenda, one might make a case for a HQS concept either (a) to identify the very safest securitisation exposures, or (b) to set minimum disclosure, simplicity, etc. criteria for 'acceptable' securitisations, in the light of lessons learned since the crisis. We suspect that, in either case, those not meeting the relevant quality level would be penalised (relative to what a simple economic risk/capital neutrality approach would suggest), rather than that those meeting the standard would be privileged with treatment better than analysis of economic risk would suggest.

We believe that both as a policy matter and from a commercial perspective, using HQS to set minimum criteria would be the better approach. Using capital rules to support the market in securitised debt products that are felt to be exceptionally important for the real economy is more difficult to reconcile with the notion of a "high quality" standard for securitisation, because it seems to confuse political objectives with the prudential considerations one would more normally expect to shape capital rules. We are concerned that seeking to satisfy prudential policy considerations and broader political objectives through capital requirements risks creating confusion and unjustifiable distortions in the capital markets and by extension in the real economy. Finally, we would emphasise that (as noted in our submission to EIOPA at **Appendix 1**) entire asset classes should not be excluded from privileged HQS-type treatment in any event. Capital rules should not be used to compromise the ability of the financial system to serve whole swathes of the real economy (such as the built environment beyond privately owned housing).
8. Do you think the public authorities should set out criteria for a particular set of 'high quality' securitisations? What do you consider the benefits of this approach would be?
For the reasons discussed in our response to Q7, we have significant concerns about this approach if it seeks to privilege a limited category of securitisations by reference to features other than their complexity and transparency.
9. What type of firms would you consider the most appropriate investor base for 'high quality' securitisation?
We have commented in our response to Q7 on the difficulty we have in grasping what exactly the HQS concept is seeking to do, and what it therefore needs to describe. Leaving those points to one side, we find this question difficult. Even assuming we are talking only about banks (rather than the wider universe of securitisation bond investors), we would not necessarily expect there to be "types" of investors for which HQS bonds are appropriate. What should other types of investors be doing – not investing in securitisation at all, or investing in "low quality" securitisation? If "high quality" means low risk, the answer surely depends on the risk/return any particular firm wants from any particular euro of capital in a (presumably) diversified portfolio. The same is of course true for other, high risk, "low quality", exposures (whether securitisation or not), assuming they do not attract penal capital treatment such as to render investment in them uneconomic. If "high quality" means structural quality, equivalent to a best practice kitemark for transparency, simplicity, etc., the answer would surely be "all types", and the aim would presumably be to marginalise "low quality" securitisations (i.e., the scenario described in our response to Q7 where HQS is used to set eligibility standards for securitisations to attract 'normal', rather than penal, treatment). If "high quality" somehow refers to high liquidity, banks would presumably like HQS for the LCR.
10. Are there any trade-offs between encouraging low risk securitisations and encouraging securitisation as a funding tool to benefit the real economy?
See our responses to Q7 and Q9. This question too suggests that "high quality" means "low risk". On that basis, there is a big trade-off, because *many of the good things that need finance in the real economy are not low risk*. High risk finance (including when it is securitised) should carry an appropriate capital charge having

regard to the assessment of economic risk, and perhaps also to appropriate structuring, transparency, disclosure and pricing of risk – but it should not be positively penalised by capital rules seeking to favour "low risk" securitisations. Otherwise, debt finance will either stop reaching whole areas of the economy, or it will migrate to less visible, less regulated parts of the financial system.

The tranching and credit enhancement that securitisation allows can of course also be used to create privileged, "low risk" exposures from higher risk underlying loans. That brings us back to the question of capital neutrality and the policy objectives of this whole discussion.

Historical performance of different classes of securitisations

11. Historical default/impairment data is one of the criteria commonly used to evaluate the performance of different securitisation classes. Data on default/impairment for the 2007-2009 time clearly that certain classes of securitization performed differently.

- **a. Where certain classes of securitisation suffered few losses over this period, what were the key drivers of their better performance?**
- **b. Where certain classes of securitisation suffered greater losses over this period, what were the key drivers of their worse performance?**

It is important to make two introductory comments here.

First, it is unfortunate that we lack any organised database of commercial mortgage performance in Europe. Despite the economic and systemic importance of this sector, it has remained a private market with very limited market and regulatory visibility. It is thanks to CMBS that we have some transparency, because of the bond, loan and asset level reporting that is provided for investors in public commercial mortgage backed bonds.

Secondly, European CMBS is a product still in its infancy. It only emerged as the most recent commercial property boom gathered pace. We learn when things go wrong – and the global financial crisis was the first opportunity that European CMBS has had to recognise and address its mistakes and to reinvent itself. While there were weaknesses in the CMBS market itself, major contributors to its volatility and performance in the last few years were:

a) declining underwriting standards in the CRE loans being written from around 2005 onwards in an increasingly overheated property market, itself fuelled by the highly pro-cyclical credit cycle, and

b) the sad fact that, alongside many CRE loan originators (whether originating to distribute or for their own balance sheet) and investors, many governments, central banks, financial regulators and rating agencies all shared the belief that we were experiencing a "new paradigm", that it was "different this time", that we had "abolished boom and bust", and that no counter-cyclical intervention was needed. European CMBS may have performed worse than US CMBS and other European ABS – but the product is not fundamentally flawed.

The draft recommendations of the Vision for Real Estate Finance in the UK (**Appendix 2** to this response for ease of reference) are designed to address, among other problems, the CRE debt market's informational deficit and the desperate need for greater counter-cyclicality and better risk management tools (for lenders and regulators). We believe that taking those recommendations forward is the best way to tackle the issues that blighted the first decade or so of CMBS in Europe.

Based on a review of Trepp's database of over 1,100 CRE loans securitised since 2000 (amounting to

approximately EUR139bn of European CMBS):

- Losses amounted to 1.3% of the aggregate original loan amount (9.1% of loans by number experienced a loss).
- All of the loans that experienced a loss were securitised in 2005, 2006 or 2007, as the market approached its peak.
- The loan to value ratio (**LTV**; by reference to market value) of new loans was broadly constant leading up to 2007.
- The probability of default rises sharply where the original LTV exceeds 60%. Below 60% the probability of default is 1%, rising to 18% where the original LTV exceeds 80%. Loss severities reflect a similar pattern.
- The probability of default rises sharply where the original interest cover ratio (**ICR**) is below 1.5x. Loss severities reflect a similar pattern.
- The loss severity of 2007 vintage loans was roughly the same whether the loan was secured by properties located in Germany or the UK (at 33.1% and 32.3% respectively).

Among CMBS bonds with an initial AAA rating, total realised principal losses to date (since the earliest issuance in 1996) amount to around 0.2% (loss severities covered a very broad range, reflecting very diverse features in transaction and capital structure). Both actual losses to date and likely future losses (as reflected in rating downgrades) on CMBS bonds initially rated AAA are concentrated in the two or three years leading up to the global financial crisis. **Appendix 3** to this response provides some further analysis.

We draw the following conclusions:

- Vintage is the biggest driver of defaults and losses. Using sustainable (rather than market) value when measuring LTV, as recommended by the Vision for Real Estate Finance in the UK, would help to mitigate both.
- Leverage, expressed in low ICR and high LTV, are the next biggest drivers of defaults and losses.
- Geography (including country) appears not to play a significant role in the probability of loss or loss severity (sufficient data is only available for Germany and the UK).

The critical importance of vintage indicates a failure of cyclical risk management at the level of loan origination. In other words, the problem is overwhelmingly at the level of the loans, not the CMBS. We support the recommendations of the Vision for Real Estate Finance in the UK (**Appendix 2**), the only study of its kind of which we are aware, to address the problem. Particularly important, in our view, are the recommendations for a loan-by-loan database; the use of sustainable long-term value based LTV for risk management, both by regulated lenders and by the capital regime; and the diversification of the CRE debt market, including through the bond markets, to reduce the dominant role of the banks and improve secondary liquidity to support access (and risk transfer) to non-originating investment capital. Building best practice around CRE loan characteristics, disclosure and metrics generally would support the development of CMBS eligibility criteria at the loan level, making the product simpler, more transparent and more attractive for investors.

12. Are there any other insights which can be drawn from historical data on securitisation over a longer time period?

For CMBS and CRE debt more generally, that data is simply not available, unfortunately. One might point to a decade or so of very good performance by European CMBS until losses first arose in 2009 – but while that is partly the result of the very high quality of property, borrowers and structures in the early years, it is also partly the result of where we were in the CRE (and credit) cycle.

There is better evidence available from the US where, according to data from Trepp, historic losses over the period since 1997 (covering two downturns) are 2.79% for CMBS generally and 0.25% for deals involving a single borrower and no more than a small pool of cross-collateralised assets.

13. What criteria should be considered, beyond historical default/impairment performance, to assess the safety and quality of different securitisation products?

Cumulative losses on European CMBS are almost certainly significantly lower than the losses suffered by European banks on their (unsecuritised) CRE loan books. While securitisation structuring and the quality of external ratings are important factors that shouldn't be ignored, fundamentally the performance of CMBS is a function of the underlying loan market.

As previously mentioned, the CRE debt market is heterogeneous and lumpy, covering an extraordinarily broad range of risk profiles, which is not readily susceptible to statistical analysis. Reliable public data is remarkably limited in this market, which remains overwhelmingly private (CMBS being the worthy exception). The one constant is the volatile CRE cycle, and its mutually reinforcing relationship with the credit cycle, and, traditionally, unmitigated by any meaningful countercyclical action by regulators. The cycle means that vintage is the best indicator of performance.

Too often, market participants (and their regulators) forget that CRE is a specialised asset class: buildings are depreciating assets whose value should be driven by fairly stable sustainable cash flows, but is rendered highly volatile by the yield compression and expansion (i.e., the multiple that markets are prepared to apply to those cash flows at different points in the cycle).

The Vision for Real Estate Finance in the UK (**Appendix 2**) seeks to address those underlying problems in the CRE debt market and its regulatory framework. We think that would be the best way to improve the quality and performance of CMBS. A degree of standardisation and broader consensus around best practice could lead to accepted eligibility criteria for CMBS – something that the European CMBS market has not really had in the past.

In parts of the European CRE debt market, the dominance of floating rate debt and the consequent reliance on interest rate hedging and risks connected with the way that was structured (and with the unprecedented period of very low interest rates of recent years) also contributed to the stress the sector experienced. That may also have affected CMBS, where investors may not have had good visibility as regards the hedging arrangements.

More specifically at the CMBS level, the tools available to manage risk are subordination, LTV levels and overall leverage, structural enhancements, the tail period between loan and bond maturity, etc. In general, rating criteria (especially following improvements made in the aftermath of the crisis) are good at identifying relevant features and indicating risk.

Criteria for differentiating among securitisations

14. Which are the main structural features of the transaction relevant to the overall safety and quality of securitisation products from an investor perspective?

We would argue that the characteristics of the underlying loans and properties have a greater impact on performance than the structural features of the subsequent securitisation transaction.

Despite the relatively poor performance of late pre-crisis vintage CMBS during the crisis, the performance of senior bonds in particular was good and broadly in line with initial expectations in the face of a very severe CRE market downturn. Specifying loan level criteria for due diligence, security and reporting from the borrower level that must be satisfied for loans to be CMBS-eligible would be a useful step.

Having said that, as far as structural features of the securitisation transaction are concerned, we would identify the following (all being matters that would be taken into account by credit rating agencies):

- True sale / bankruptcy remoteness
- Credit enhancement through tranching, over-collateralisation and subordination
- Transparency and simplicity of structure generally
- Payments waterfall
- Liquidity facilities to cover interest and expense shortfalls
- Financial covenants, etc. to monitor performance and risk (LTV, ICR, DSCR, debt yields, etc.)
- Tail period
- Treatment of excess spread and cash trapping
- Repurchase obligation where originator breach of representations/warranties
- Servicing and servicing continuity

15. Are there any originator characteristics that are relevant to the overall safety and quality of securitisation products from an investor perspective?

The most important originator characteristics are its underwriting philosophy and quality, adherence to such industry standards as are considered best practice in the relevant jurisdiction, its track record and alignment of interests with investors. Beyond that, the originator's needs to have the financial ability to honour repurchase obligations in relation to securitised loans and otherwise to meet its obligations for breaches of representations or warranties. The real estate sponsor, the quality of servicing and servicing continuity are also important.

Encouraging broader consensus across the European CRE debt industry as regards appropriate loan level practices, standards, documentation and reporting would add to the differentiation between originators who complied with such standards and originators who did not.

16. Which are the main features of the underlying assets in the transaction to the overall safety and quality of securitisation products from an investor perspective? If you are in favour of including/excluding specific underlying asset types, which ones would you include/exclude?

As previously explained, CRE is an unusual securitisation asset class because of the size and heterogeneity of commercial property, and because of the ability to achieve effective risk diversification at the tenant level regardless of the number of borrowers. The characteristics of CRE loans are influenced by those features of CRE itself, as well as by the quality of underwriting more generally and the use of counter-cyclical risk management tools, for example to avoid the deceptive effect of rising asset values on LTV tolerances. The vintage of loans is a better indicator of loan performance than any other feature, including the quality of the underlying assets.

As also previously stated, we do not support an approach that automatically includes or excludes any underlying asset type for the purposes of a HQS definition. By contrast, there is a place for loan level or portfolio level eligibility criteria *within* asset classes – and CMBS has suffered because it did not previously have any. One obvious criterion in the CRE context is that CRE lending to support construction or development activity or land banking – where outcomes are highly dependent on volatile capital values and there is little or no stable regular income – is not suitable for securitisation. For stabilised assets, criteria might be linked to leverage and cash flow measures

(ideally on a cycle-insensitive basis).

Based on our response to Q11, the single most important thing would be to identify with reasonable accuracy where we sit in the CRE and credit cycle at any particular point, so that lending (and issuance) do not increase, and become riskier, in the years immediately before a crash. The best way to do that is to collect and publish better data about the underlying CRE loan market, and to build counter-cyclical mechanisms into banks' risk management processes and regulatory capital rules. A long term sustainable value measure should be used in calculating LTV. Particular weight should also be given to other cash flow-focused metrics, such as ICR and debt yields at maturity.

Beyond that, greater market adoption of best practice standards around lending criteria and reporting would improve both transparency and quality.

17. Are the existing transparency requirements in EU legislation and other market standards sufficient to ensure the overall safety and quality of the securitisation products from an investor perspective?

CMBS is by far the most transparent part of what is a fundamentally private market in CRE debt with limited granular information available even to regulators, let alone the market. Generally, we think existing requirements for CMBS are adequate.

18. Are concentration / granularity of portfolios relevant to the overall safety and quality of securitisation products? Would a definition of granularity based on economic sector and/or geographical location be useful?

These are indeed important factors affecting credit risk on ABS, and they are taken into account by the rating agencies when they work out the subordination level needed for any given rating. However:

- These are by no means the only factors – US subprime RMBS had huge numbers of loans and borrowers and were highly geographically diverse. A CDO with significant numbers of bonds will have enormous diversity in terms of underlying loans, borrowers and geography. So while these factors are "relevant" to the overall safety and quality of the ABS product, they are far from decisive.

- As previously explained, CRE is a fundamentally different asset class, capable of delivering granularity and diversification and of addressing concentration risk at the tenant level, potentially more effectively than can be achieved at the loan/borrower level. A single large shopping centre may have 100 tenants, large and small; a small portfolio of office developments may have dozens of tenants.

- More particularly, CRE is overwhelmingly about individual buildings – the volatility of individual building returns within a single locality can be enormous, and geographical diversification is not a reliable way of diversifying risk (evidence available on request). The same must be true of the economic sectors to which a real estate portfolio (and thus the debt secured on it) is exposed.

In the light of those points, we are not convinced that granularity of portfolios contributes to the safety of CMBS – indeed, some of the safest CMBS (and the most attractive from the point of view of investor due diligence) are highly concentrated portfolios, often described as 'single asset single borrower' CMBS. Accordingly, we do not think a 'one size fits all' approach to defining granularity and concentration would be appropriate.

19. Does the synthetic Vs 'true sale' type of transaction affect the overall safety and quality of the securitisation product?
Potential weaknesses in synthetic structures include (a) if the loan servicer's duty of care is to the originating bank rather than to the CMBS issuer; (b) that access to and control of the underlying assets is less straightforward, so it may be harder to address performance issues; (c) that the investor may be exposed to credit risk on the swap counterparty. However, most of these problems can be addressed through transparency, legal protections and alignment of interests.
20. Does the level of leverage affect the safety and quality of the securitisation products? In which asset classes?
Leverage is definitely an important risk factor in CRE – but how it is assessed is key: LTV calculated by reference to market value can give a very misleading picture, for example, compared to if it is calculated by reference to a long term sustainable value. Once CRE loans are securitised, higher leverage at the loan level should, at least in theory, be offset by higher credit enhancement at the bond level, impacting on subordination levels. Provided loan level leverage is properly assessed and understood (which has however not always been the case), there is no reason for it to affect the position of senior investors at the bond level.
21. Does the level of maturity mismatch (re-financing risk) between underlying assets and liabilities affect the safety and quality of the securitisation products? In which asset classes?
It is a significant issue, which is mitigated in CMBS by the use of a fixed pool of loans with a tail period between their maturity and bond maturity. However, while that addresses maturity mismatch between underlying assets and the bonds, refinancing risk remains. The limited use of amortisation coupled with the traditional reliance on (highly volatile) market values in determining LTVs (a key metric when writing loans and when securitising them) mean that loans maturing during a trough in the CRE cycle can give rise to losses for bondholders. In CMBS issued since the global financial crisis, due to structural features, the maturity mismatch is unlikely to be an issue for senior bonds (although it may be for mezzanine and junior bonds).
22. Do you consider the criteria proposed by EIOPA in their Technical report on Standard Formula Design and Calibration for Certain Long Term Investments (published on December 19th 2013) to differentiate between securitisations by Type A and Type B appropriate? What are the main benefits and drawbacks of this approach?
We do not support the approach adopted by EIOPA and consider it problematic both in principle and in its particular implications for CMBS. We refer you to **Appendix 1**.
23. How do the PCS label criteria differ from the EIOPA criteria?
We have no comment on this question.
24. Do you consider the PCS label criteria an appropriate way to identify 'high quality' securitisations? What are the main benefits and drawbacks of this approach?
We refer you to our responses to earlier questions. Generally, we have significant concerns about a binary approach to classification, particularly if it is driven by competing (and arguably incompatible) policy objectives and lacks the sensitivity, accountability or flexibility of external ratings.

25. Are there any other criteria (in the EU or abroad) that could inform the discussion?
Besides rating criteria, we think it may be worth looking at the US "qualifying loan"/"qualifying securitisation" concept embedded in the risk retention regime. That concept is asset insensitive, but includes a tailored set of underwriting, disclosure and structuring criteria for each asset class that must be satisfied in order for exemption from risk retention requirements to be available.
Preferential treatment for "high quality" securitisations
26. Should EU regulators differentiate the prudential treatment of securitisations by treating different product categories differently? If yes, please explain why.
Based on our current understanding of how the HQS concept is being developed, we would not like to see capital treatment linked to it, as it feels insufficiently robust, driven by competing (and arguably incompatible) policy objectives, crude and inflexible. It is difficult to see how capital requirements linked to it could remain firmly connected to economic risk and respect capital neutrality. More generally, we refer you to our responses to other questions.
27. In which regulatory areas (capital, liquidity, collateral, other) should a preferential treatment be given to "high quality" securitisations?
We can see a rationale for liquidity rules to give preferential treatment to more liquid assets (not necessarily to HQS). We remain generally sceptical of the HQS approach in other respects, as explained throughout this response.
28. How would you differentiate between the capital requirements of "high quality" securitisation and other securitisations? How would you calibrate the credit risk "high quality" securitisations to the regulatory capital requirements?
We have set out our views elsewhere in this response. We do not really understand the proposed approach to a HQS concept and would not support an approach that disconnects regulatory capital from economic risk, creates cliff-edges, and fails to respect capital neutrality.
29. If you consider a preferential capital treatment for "high quality" securitisations is appropriate, is this differentiation appropriate regardless of the overall level of calibration of securitisation capital requirements? If yes why and how would you calibrate the capital requirements both in relation to the Basel II framework and the proposals currently under consultation?
What is important is that calibrations make sense having regard to a reasonable regulatory assessment of economic risk, and respect the principle of capital neutrality as far as possible. As economic risk is a continuum, it is difficult to reconcile a capital regime that adopts a binary approach, because it is bound to drive the behaviour of investors and other market participants and the operation of the financial system more generally in unintended and potentially undesirable ways. We would support a HQS concept introduced in such a way as to marginalise bad practice by penalising transactions that failed to meet simplicity, transparency etc. standards, and ensuring that most securitisation activity attracts regulatory treatment that aligns with economic risk and respects capital neutrality.

30. Should “high quality” securitisations be treated differently in aspects other than regulatory capital such as due diligence, retention, liquidity, reporting? If yes, please explain why, in which areas and how?
We would need a much clearer set of answers to the questions we have raised throughout this response about the HQS proposal before exploring this question.
Impacts of developing a “high quality” securitisation market in the EU
31. Do you see any risks or adverse impacts if different securitisation products receiving the same external rating are subject to different prudential treatment?
We see very real risks in this area. Given that the rating agencies are trying to assess economic risk, and on the basis that regulatory capital should be broadly aligned with economic risk, divergences between the application of the HQS label and high ratings from the rating agencies on anything more than a very occasional basis should be a source of serious concern to regulators. That is likely to happen principally because the rating agencies will have far greater practical flexibility to correct errors in their methodologies and to change their ratings than regulators are likely to have to bestow or withdraw HQS status. For example, what would regulators do if a AAA rated HQS bond were to be downgraded by the rating agencies? If (as we would expect) they did nothing, the discount margin on that bond would rise in the secondary market, so a regulated investor would be incentivised by the capital regime to sell HQS bonds that have not been downgraded and to reinvest in the one that has been downgraded. What are the implications of that kind of scenario for (a) financial stability, adverse selection risk and systemic risk more generally, (b) the development of a safe and stable securitisation market to support bank funding, or (c) the long-term financing of the European economy? Wouldn’t it be better to align capital treatment with economic risk and to strive for capital neutrality as far as possible?
32. There is regulatory activity affecting banks/insurers/money markets funds/other entities, as well as on topics relating to capital/liquidity/transparency/other requirements, and further regarding securitisations/covered bonds/other fixed income. In your view, how can preferential treatment be granted in a consistent manner for securitisations across these various requirements?
This is a complex question to which we cannot do justice without a much clearer understanding of the HQS concept – which, at this stage, we view with considerable concern. We are uneasy at the suggestion that such broad consistency as the question proposes is desirable, let alone sensibly achievable.
33. Following on from the previous question, do you see any risks or adverse impacts if differentiation criteria are proposed, in banking prudential regulation, which are different from the criteria proposed in the insurance sector (EIOPA) or other sectors?
Plainly there are arbitrage risks, etc., to be considered. But the desire to minimise regulatory arbitrage should not lead all regulators to repeat the mistakes of the first mover, especially given the significant distortive potential of the proposals EIOPA is taking forward.

34. How would the EU securitisation market develop if "high quality" securitisation was introduced in the CRR following the EIOPA criteria and if those "high quality" securitisations received the same regulatory treatment as covered bonds[1]? Please include expected growth and volumes level per asset class.
We have nothing further to add in response to this question.
35. How would preferential treatment of certain securitisations benefit the long term financing of the EU economy?
We have nothing further to add in response to this question.

[1] Please note that the comparison to covered bonds regulation is only used to provide a benchmark and facilitate a meaningful answer. This should by no means be understood as an indication of a possible potential outcome of EBA advice towards the European Commission.

Commercial Real Estate Finance Council
EUROPE

INREV

Sent by email only to: Gabriel Bernardino, EIOPA
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Klaus Wiedner, COM

With copies to: Sharon Bowles, MEP
Syed Kamall, MEP
Peter Skinner, MEP

21 January 2014

Dear Sirs,

Solvency II and securitisation – the real estate perspective

Our organisations would like to comment on the Technical Report on Standard Formula Design and Calibration for Certain Long-Term Investments (EIOPA/13/513) which was published on 19 December 2013 (the **Report**). More information about our organisations is set out in the Appendix to this letter.

Recommendation

We would encourage EIOPA to allow room for certain commercial mortgage backed securities (**CMBS**) to qualify for 'Type A' capital treatment, by reference to objective, qualitative criteria, and not to condemn all CMBS, regardless of their actual characteristics, to 'Type B' treatment. Doing so would promote valuable diversification at two important levels:

- in the investment portfolios of insurers, where CMBS have different investment characteristics from other forms of exposure to CRE and CRE debt (and indeed from other asset backed securities); and
- in the constitution of the CRE finance market, which has historically been excessively reliant on banks and the limited range of products they are willing to keep on their balance sheets, to the detriment of financial stability.

Following our recommendation would also reward industry efforts to address the problems that affected CMBS before the crisis, so that a better product can emerge in the future.

We would be happy to work with officials on the development of appropriate criteria.

Comments

We strongly support EIOPA's initiative to conduct a thorough and considered review of the treatment of securitisation bonds in general (among other long-term investments) under Solvency II.

In recent months, a growing number of policymakers and financial regulators have recognised that securitisation has an important role to play in supporting the long-term financing of the economy. For example, we understand that the International Organisation of Securities Commissions plans to

establish a working group dedicated to facilitating the growth of securitisation markets. We agree that the problems that afflicted elements of the securitisation market (especially US subprime mortgages, as the Report notes) during the financial crisis do not mean the baby should be thrown out with the bathwater.

However, we are troubled by the impact that the revised approach proposed by EIOPA will have on insurers' ability to invest in ways that make sense economically and commercially, on the CRE industry and its ability to serve the wider economy, and ultimately on financial stability.

We are particularly concerned that the capital treatment for CMBS is now set to be even worse than previously proposed. We accept that a trade-off has to be made between simplicity and fairness (and recognise the appeal of simplicity), but we do not consider it appropriate for all CMBS to be classified as higher risk, higher cost 'Type B' securitisation. CRE debt has characteristics that make it a highly appropriate component of diverse insurer portfolios, because it generates long-term, inflation-protected cash flows benefiting from security. CMBS in particular can deliver stable, long-term returns with greater risk diversification and liquidity and lower overhead costs than direct CRE lending, while also allowing insurers to select the risk/return profile that best suits their investment needs. Automatic 'Type B' treatment is likely to deter investment in CMBS by insurers, significantly reducing the options available to those that want CRE debt to have a place in their portfolios. In our view, this would not serve the interests of insurers or the insured public.

Furthermore, CRE is a socially and economically important and value-generating sector of the European economy.[1] It is capital intensive, and structurally reliant on a substantial amount of debt finance, as well as equity investment. In noting (at page 111) that SME loans are not the only channel of funding for the real economy, the Report might have also recognised the important contribution of CRE finance. Crucially, the characteristics of CRE debt mean that it is a naturally good fit within the capital allocation of insurers and other institutional investors. For that reason, unreasonable regulatory discouragement for investment in CMBS by insurers would be unfortunate, both for insurers and for the CRE sector and wider economy.

Finally, there is also an important financial stability dimension to this issue. The structure of the European CRE debt market as a whole is problematic, because it is very heavily dominated by banks, often lending on very similar terms. The result is a market that lacks resilience, as too many debt providers react to market signals in the same way at the same time, exaggerating the peaks and troughs of the cycle. This proved to be a source of material systemic risk within the EU and for the global economy. Improving diversity in sources of finance would help build market resilience and support financial stability.[2] EIOPA's revised proposal is likely to have precisely the opposite effect.

It is true that CMBS is a relatively new and small part of the CRE market in Europe, and the last few years have been particularly difficult. It has suffered from the problems identified on page 110 of the Report, namely inconsistent alignment of interests between originators and investors, and often poor investor information about the quality of underlying assets. But the industry is acutely aware of the need to address structural problems in the way European CMBS worked before the crisis. We are busy developing solutions and promoting improvements through industry dialogue, best practice

[1] The social and economic importance of CRE is explained in a paper jointly produced by two real estate industry bodies, EPRA and INREV, available here: http://www.epra.com/media/Real_estate_in_the_real_economy_-_EPRA_INREV_report_1353577808132.PDF.

[2] Promoting diversity and reducing excessive reliance on bank is a key element of the proposals of a UK real estate industry group seeking to improve CRE finance markets and their regulatory framework so that financial stability is better protected in future property market booms and busts. The initial output of that group is available here: https://www.ipf.org.uk/MainWebSite/Resources/Document/Real%20Estate%20Vision%202013.pdf.

guidelines and education and training.[3] Regulatory changes under the Capital Requirements Regulation (575/2013) designed to improve alignment of interests between originators and sponsors and investors should also assist.

Unfortunately, the proposals in the Report undermine the industry's efforts to address past problems and ensure that CMBS is a better product in the future, and make it harder for CRE debt originated by banks to be safely distributed to other financial institutions. Regulators should work together to reduce the concentration of CRE debt within the European banking system, improving its resilience. By classifying all CMBS automatically as 'Type B' securitisation, EIOPA will create an unnecessary and artificial obstacle that will make that more difficult.

There is nothing intrinsically wrong with CMBS as an instrument, any more than with other forms of securitisation. Neither is CMBS inherently riskier than other forms of CRE exposure. The risk in a bond is principally a function of the quality of the loans underpinning it. It follows that the senior tranche of a CMBS bond (the most widely attractive to insurance firms) will invariably be lower risk than the loans underpinning that bond. It is odd that the Solvency II capital regime ignores that fact, imposing higher risk weights on the bond than on direct loans. Rules that ignore economic reality will tend to distort capital allocation and investment decisions in potentially undesirable ways.

Conclusion

We are pleased that EIOPA has given such thoughtful consideration to how the capital treatment for insurers of securitisation (among other long term financial investments) might be improved.

However, regulatory capital treatment for a whole asset class that is indiscriminately penal for insurers – a core constituency of the investor base for CMBS bonds – risks reducing healthy diversification in insurer portfolios and causing irreversible damage to the CMBS market by placing it at a serious disadvantage relative to other comparable investments. The CMBS market is only gradually beginning to recover and reinvent itself post-crisis. EIOPA's revised proposals are likely to undermine the ability of a better CMBS market to support more diversified funding for CRE and a more resilient European banking sector. The supply of credit to the CRE industry, and thus the CRE industry's ability to serve occupiers and the economy at large, are also likely to suffer as a result.

We would welcome an opportunity to explore with you how the treatment of investments providing exposure to commercial property might be adjusted so as better to reflect economic risk, motivate product improvement, and address what are in many ways the shared interests of insurance firms and their customers, the real estate industry and financial stability.

Yours sincerely

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[3] For example, CREFC Europe's November 2012 document, *Market Principles for Issuing European CMBS 2.0*.

Appendix

CREFC Europe

The Commercial Real Estate Finance Council (**CREFC**) Europe is the voice of the commercial real estate (**CRE**) finance industry in Europe. It is our role to promote transparency and liquidity in CRE finance markets by developing and disseminating best practice and engaging with regulators, so our industry can flourish while playing its part in supporting the real estate sector and the wider economy. In addition, we act as the meeting place for the CRE finance industry, its constituent elements and its customer bases (those with capital to invest and those seeking finance), and provide education and networking opportunities for market participants. After the difficult years of the global financial crisis, we want to ensure that the industry we champion has a bright and sustainable future.

INREV

INREV is the European Association for Investors in Non-listed Real Estate Vehicles. Since its launch in 2003, it has grown to almost 350 members from more than 28 different countries. INREV's aim is to improve the accessibility of non-listed real estate funds for institutional investors by promoting greater transparency, professionalism and standards of best practice. INREV is led by institutional investors and supported by other market participants including fund managers, investment banks, academics, lawyers and other advisors. As a pan-European body, INREV represents a unique platform for sharing knowledge on the non-listed real estate funds market.

A Vision for Real Estate Finance in the UK

DRAFT RECOMMENDATIONS BY A CROSS-INDUSTRY REAL ESTATE FINANCE GROUP

An industry discussion

Sponsored by:

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Background

The UK banking and commercial real estate (CRE) sectors have emerged battered from the global financial crisis (GFC). This document seeks to outline some initial recommendations, for public feedback and comment, as to how such an undesirable outcome from the next CRE market crash can be mitigated, following which a final report with recommendations will be made.

To a large extent, financial crises, including the GFC, have been caused or prolonged by imprudent CRE lending by financial institutions – particularly systemically important deposit-taking banks. In the UK, as a result of the GFC, several banks remain mired in a slow and painful resolution of often challenging legacy loan books from the boom years. This has significantly hindered banks' ability to provide new credit to support economic recovery, just at the time when such support is most critical. Meanwhile, regulatory response to the GFC has reflected a blend of expedient short-term objectives, the fragmentation of regulatory regimes (UK, EU, US and international) and public/political reaction to the crisis as well as a desire to ensure in the medium term that banks become more robust to future crises. Such a diverse range of drivers threatens to generate overregulation, which risks stifling recovery and growth, and a series of potentially inconsistent and incomplete regulatory regimes that together are unreflective of an overall considered vision. Moreover, if history is our guide, such overregulation is likely to persist precisely during the period when it is least required, with a return to lighter touch regulation coinciding with the return of over-exuberance to the market.

Over the last two years, there has been much discussion in the CRE sector about how lending to the CRE sector can be restored as well as the potential impact of impending regulation. These culminated in the Property Industry Alliance Debt Group's report, produced in mid-2012, and presented to the Bank of England's Commercial Property Forum. That report highlighted a number of concerns about impending regulation and CRE financing and recommended the creation of a cross-industry group of informed individuals to consider a market structure and regulatory regime, which could be implemented in time for the next crisis, in order to protect the financial markets against the CRE cycle, yet ensures adequate debt support for the CRE sector across the cycle. The suggestion was received favourably and a cross-industry Real Estate Finance Group (the Group) was formed. While the Group anticipated constructive engagement from regulators, it is an industry initiative that retains complete freedom to make whatever recommendations it considers appropriate, and which in no way commits regulators to any course of action. The Group benefits from the sponsorship of the Investment Property Forum (IPF), while retaining full editorial control over its recommendations.

Members of the Group have been selected to ensure knowledgeable and expert representation from a wide spectrum of the CRE market, including CRE specialists from organisations that provide finance to that market. Each member's participation is in an individual capacity, such that the recommendations are those of the Group, and may not necessarily reflect the views of their organisations.

Further details of the Group and its remit are set out in the Appendix to this paper.

Scope of the Vision

The scope of the Vision project warrants emphasising. The ongoing fallout from the global financial crisis raises two broad questions for the CRE industry. The first relates to whether, and how, the resolution of the legacy position can be accelerated and improved so that the industry can operate and support economic growth more effectively. The second relates to whether there are lessons to be learned from the experience of the last few years in the UK and elsewhere for the future: Could CRE finance markets be encouraged to function differently and might they be regulated differently, so as to reduce the threat the real estate cycle can pose to the stability of the financial system, while ensuring that the CRE sector is adequately supported by debt finance across the cycle?

The Vision project does not seek to address the first question, and the immediate task of helping to extricate the industry and the financial system from the predicament of the last few years. Its focus is exclusively on trying to answer the second question – envisioning a better functioning and better regulated CRE finance market that might be delivered over the next several years, with the primary goal of limiting the impact of the next property crash on financial stability.

The expectation is that the CRE finance market can be evolved to implement the Vision over the period before the next crash, with all new regulation in that timeframe being consistent with and supportive of it. Given this timeframe, the Group has left detailed consideration of timing and implementation to a later stage of this process, which is likely to be led by those responsible for implementation.

The Group considers that this approach will generate more valuable and effective recommendations.

A Vision for Real Estate Finance in the UK

THE ENVISIONED MARKET

The Vision is for a CRE market and regulatory regime that:

- Protects systemically important financial institutions and the financial system more generally from the CRE cycle, in particular by ensuring that such financial institutions hold sufficient capital to withstand a market crash;
- Reduces pro-cyclical tendencies, by moderating the flow of credit to the CRE sector and ensuring financial institutions are positioned to support CRE lending after a market crash; and
- Promotes the contribution of the CRE sector to the economy, by supporting the availability of CRE debt funding across the cycle.

The Group has approached these objectives from a number of angles, and its different work streams have developed a number of provisional high-level recommendations.

A RESILIENT MARKET SUPPORTED BY REGULATION

As a starting point, the Group has accepted the commonly-held view, that markets are more effective and productive generally when intervention, which is distortive, is kept to a minimum. At the same time, asset bubbles are a recurring feature of market cycles, and the GFC has revealed that financial markets have the capacity to become self-destructive, with implications beyond the markets themselves. It seems clear that a more effective market and regulatory framework is required – but it must be informed, focussed and proportionate, and avoid distorting markets unjustifiably.

The Group believes that the features of an effective CRE market and regulatory framework in this context are as follows:

- Participants, potential participants and regulators are **informed** by good quality, granular, real-time data and by expert analysis and advice;
- The CRE market and regulatory structure actively **encourages industry self-management**, through market participants developing and promoting good practices, thereby reducing the need for regulatory intervention;
- The regulatory approach is instinctively **supervisory** and encouraging before it is interventionist;
- The regulatory framework adopts graduated, and largely automated **'governor'-based interventions** – applied incrementally as the CRE market moves through the cycle – to influence market behaviours, rather than blunt instruments and 'on/off' switches;
- Regulatory measures and incentives act as **counters to pro-cyclical tendencies**; and
- Regulators are **adequately resourced and supported (by Government and the CRE industry)**.

The recommendations discussed below seek to translate these features into concrete proposals.

Realising the Vision – Recommendations

A. INFORMATION ABOUT, AND ANALYSIS OF, THE MARKET

(i) A CRE loan database

Market participants, potential new entrants, regulators and others need to have good quality, granular and timely information to analyse and interrogate in order to improve their understanding of the CRE loan market and enable them to make better decisions.

Recommendation 1

Recommendation: A database of all UK CRE loans (whether originated or held by UK regulated banks or by other market participants), appropriately populated, should be mandated.

Key market lenders should be required (for their own risk management purposes) to maintain real-time risk analysis of their books (akin to those expected for trading operations) – including appropriate 'stress-testing' of positions – with the regulator having real-time access to individual lender risk analysis as well as overall market risk analysis.

Aim: To ensure lenders and regulators have the information they need to understand the risks that are being taken and to have it within a timeframe that allows them to respond in times of market stress.

To allow academics and others to undertake analysis and provide insights, including warnings of overheating, to lender, borrower and regulatory participants.

To reduce barriers to entry for new lenders, thereby facilitating diversification of lenders, and the more rapid entrance of new lenders who can support the market in the event that existing participants withdraw.

To support a cost-effective and consistent approach to loan valuation by providing a common information source.

Issues: There is a tension between the desire for widely available, fully granular information and confidentiality concerns. The database should be public, in a form that reflects maximum granularity and manipulability of information so as to enable market participants, academics and potential new entrants to analyse the market, but it must be subject to such restrictions and controls (over reports and base data) as are necessary to maintain public anonymity for individual lenders and borrowers.

(ii) An expert advisory committee

Essential to effective regulation is access to the best possible information and analysis, in a timely manner. The regulator needs adequate skills and resources to assess the CRE market data and analysis, but this should be enhanced significantly by the analysis and insights of experts and commentators.

Recommendation 1 (CRE loan database) enables academics and CRE market participants to analyse the overall CRE loan market and comment accordingly.

Even with a wealth of data and analysis, it can be challenging for a regulator to interpret the overall picture clearly and in particular to:

- Assess whether the data that is collected (to show where we are in the cycle and whether market self-management is working in other respects) is adequate, or whether the choice of the data that is collected needs to be modified in some way; and
- Analyse the data and interpret analysis of commentators to determine whether the operation of regulatory governors can be left 'on automatic' or whether different intervention (or its absence) may be more appropriate.

The Group recommends that the regulator should seek advice from a committee created for this purpose and comprising industry experts.

Recommendation 2

Recommendation: A committee of senior expert individuals from the CRE industry, together with others with broader, macro-economic expertise, should be set up with a duty to interpret all relevant indicators of the CRE market position within the cycle, and against the context of the wider economic environment, and communicate its views to the regulator.

Key CRE market cycle and crash warning metrics to be monitored alongside broader macro data and acted upon; the list of CRE metrics to be dynamic, and regularly reviewed for relevance.

The regulator should have sufficient, experienced and skilled resources at its disposal to enable it to carry out its duties effectively.

Aim: To inform the regulator and CRE market, by reference to objective metrics and expert views, of where the market lies in the cycle, to enable market governors (Recommendation 7) to be applied.

To enable the best regulatory response as the market cycle evolves.

B. EDUCATION AND QUALIFICATIONS

Market participants in key roles need to have the necessary skills, experience and influence to be effective in their support for, and implementation of, the desired CRE market.

Recommendation 3

Recommendation: Key members of (all lenders not just bank) CRE lending teams and credit functions with responsibility for UK CRE lending should be required (through self-regulation or imposed regulation) to have an accredited 'CRE lender qualification', maintained through continuing professional education.

- Junior members – focus more on loan and asset level training.
- Senior/credit – focus on CRE loan portfolio risks and CRE cycle.

Aim: Lending initiators, decision makers and macro risk managers will have the skills and experience to understand the risks arising from individual property loans, the portfolio and the impact of the property cycle; thereby having the capability to ensure property risks do not threaten their organisation.

C. INCENTIVES FOR INDIVIDUALS

Clearly, it is essential that those involved in CRE lending are incentivised in a manner that both supports and does not undermine the desired CRE lending market.

The Group is of the view that incentives for bank employees have already been the subject of considerable public discussion and recommendation, so does not feel the need to duplicate this work. In summary, CRE lenders should be appropriately incentivised to make good loans, having due regard to economic risk and reward, and to manage them well. To that end, their reward needs to have an element that reflects the longer-term performance of the CRE loans they make and manage.

D. INCENTIVES FOR LENDING INSTITUTIONS TO REDUCE PRO-CYCLICALITY AND REDUCE SYSTEMIC RISK

Regulatory capital requirements are an essential tool in the armoury of the regulator to create a framework within which the market can self-manage. To be effective, regulatory capital requirements should be well aligned with economic risk, recognising that:

- Economic risk can be difficult to assess accurately; and
- A difference may exist between economic risk from the point of view of the lending institution and economic risk from the point of view of the financial system as a whole. Capital requirements offer a way of 'internalising' systemic risk arising from actions and decisions of individual lending institutions.

Regulatory capital requirements do not apply to, and are not appropriate for, all CRE lenders. As a general matter, they should only apply to types of lender that are (as a category) systemically significant. At present, that obviously encompasses banks, may apply to certain other financial institutions such as insurance firms, but correctly does not extend to alternative investment funds. The rules already contemplate differentiated capital requirements, having regard to the extent to which a particular institution is systemically significant. It is appropriate that the overall scope of capital requirements be kept under review and, in particular, that regulators maintain vigilance for new types of CRE lender becoming systemically important, either individually or together.

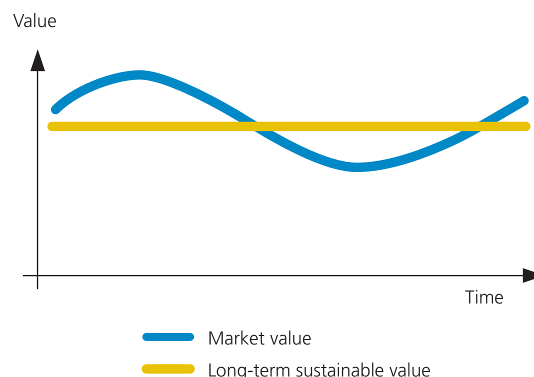
The way in which regulatory capital requirements deal specifically with CRE lending risk is very important for at least three reasons. First, UK banks continue to be the dominant provider of debt funding to the UK CRE sector, and CRE lending may exceed 10% of total bank lending late in the cycle. Second, real estate lending has a history of causing serious problems for individual financial institutions and helping trigger financial downturns. Third the relative treatment of CRE lending and other forms of lending can cause capital to be diverted either into, or away from, real estate, to the detriment of the economy as a whole. The Group believes that the rules in this area could be improved significantly by following Recommendations 4 and 5 below.

(i) Economic risk in real estate lending and regulatory capital requirements – property valuation

Perhaps one of the hardest – as well as the most important – judgments faced by CRE lenders and regulators alike is assessing the level of risk arising from CRE loans. Here there has been overreliance on loan to current appraised value (current appraised LTV). This is particularly problematic because it is doubly pro-cyclical: Lenders will increase the loan-to-value (LTV) levels at which they are prepared to lend as values become inflated, and reduce them when values have collapsed. As well as allowing riskier lending, it allows existing borrowers to extract equity from existing CRE investments through re-gearing, making the stock of past lending riskier.

The increased risk arising as the market overheats can be mitigated significantly through the use, in addition to current appraised LTV, of a measure that compares the amount of the loan to the long-term sustainable value of the property (long-term sustainable LTV) – being the average value of the property through the market cycle. Under this approach, the most important element of pro-cyclicality would be removed. A valuation approach along those lines underpins Germany's Pfandbrief market, albeit this is based on a significantly more cautious valuation, and the credit rating agencies have also developed models designed to focus on through-the-cycle value, as this allows a better insight into the risk involved.

Long-term sustainable value



Recommendation 4

Recommendation: Regulatory capital requirements for CRE lending should be linked to a property's long-term sustainable LTV, rather than its current appraised LTV.

Aim: Ensures build-up of adequate regulatory capital as a market rises, providing lenders with the desired level of regulatory capital after a CRE market correction.

It would also act to dampen credit growth during a boom, reducing the potential for regulated lending to 'feed' a CRE bubble, by breaking feedback loops between valuations and lending.

Issues: Long-term sustainable LTV should be assessed by an independent external valuer at inception and during the term of each loan (in addition to, and not in substitution of, current market valuation).

The use of LTV-based caps is specifically not recommended.

(ii) Economic risk in real estate lending and regulatory capital requirements – effective risk differentiation

While real estate lending can be very risky, particularly in the feverish atmosphere of a boom, it can also be very safe (throughout the cycle), particularly where the nature of the loan, the asset and cash flows are favourable. Defining a formula to measure the safety of any loan reliably would be very difficult, due to the varying weighting one should attribute to different characteristics when comparing loans – there must always be a judgmental element, as well as consideration of all the relevant information. However, a simple focus on LTV suggests an inflection point below which the risk of loss is very low indeed, particularly if value is assessed for these purposes on a long term sustainable basis as proposed in Recommendation 4.

Favourable regulatory treatment for loans that fall below a sensible long-term sustainable LTV level would have minimal additional impact on the risk of failure of significant lenders. Furthermore, it would positively encourage lending to support the property sector's contribution to the economy, even in the challenging times following a CRE market crash, when the economy is struggling to recover from recession. Regulatory

intervention designed to restrain exuberant lending should focus on imposing higher regulatory capital cost on lending at higher long-term sustainable LTVs, in a graduated way, reflecting the accelerating risk of loss (to the lending entity and economy) that arises from such lending. As long as the capital charges on regulated lenders were sufficient to offset their natural advantages in lending, this would likely enable and encourage non-systemic institutions, such as debt funds, to provide higher LTV and mezzanine lending, at commercial prices reflective of risk.

Recommendation 5

Recommendation: The basis for regulatory capital requirements should reflect better the level of actual risk arising from CRE loans, with greater differentiation of capital requirements between loans.

Very low-risk CRE lending (even if unrated) should be recognised as such for banks, including their use as collateral.

Aim: To remove the disincentive for regulated entities to advance low-risk CRE loans, and discourage higher-risk loans appropriately.

To encourage increased safe lending supportive of investment after a CRE market crash.

To reduce the risk of distortion that arises when similar risks in real estate lending and other lending are treated in very different ways by regulatory capital rules.

Issues: While the Vision should be to achieve more granular and more appropriately calibrated 'slotting', pending that, under currently applicable international rules there are two obvious ways of implementing an improved, more differentiated regulatory capital framework for CRE lending:

- Carefully calibrated implementation guidance for 'slotting' by UK regulated firms; and
- The development of appropriately structured, internal ratings-based models by UK regulated firms.

Neither route is without its challenges, but since changing the international rules would be a slow, difficult and uncertain process, they may be the most practicable ways of delivering the vision in the medium term.

A complementary approach might be to focus on UK regulators' existing powers to use sectoral and cyclical capital buffers so as to target disproportionately the riskier CRE lending when the market is overheating.

E. MARKET-WIDE COUNTERS TO PRO-CYCLICALITY

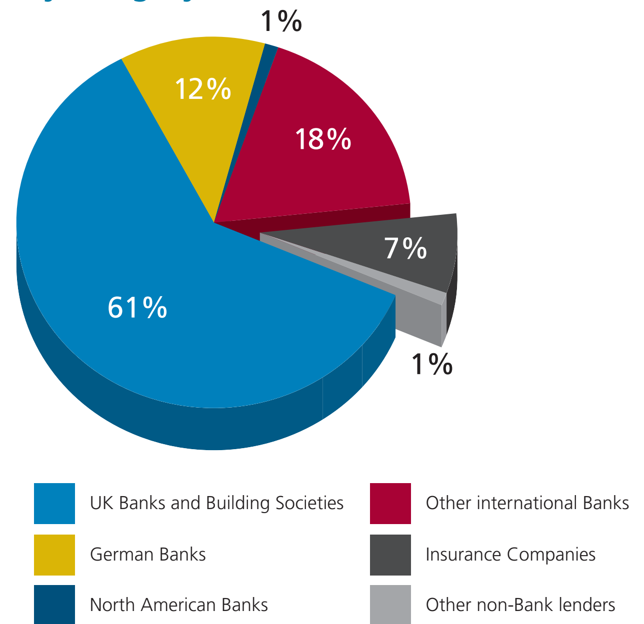
The use of long-term sustainable LTV in real estate lending, for the purposes of setting associated regulatory capital requirements (Recommendation 4), should make a valuable contribution to moderating the extremes of the real estate cycle, dampening excessive exuberance near the top of the cycle, and keeping credit flowing at the bottom of the cycle. However, more can and should be done to build resilience into the CRE finance market.

(i) Resilience through diversity

An undesirable feedback loop arises when key financial market participants respond to stress by reducing CRE lending, which then adversely affects values and thereby causes further stress in CRE loan portfolios and consequently CRE lender balance sheets and (currently) regulatory capital. If CRE lenders representing a material part of the CRE loan market make the same decision to reduce real estate lending at around the same time, as might happen in a banking crisis, they will see higher CRE loan losses as a result. To mitigate the potential impact of such feedback, the CRE market would benefit from being structured to ensure 'diversity of response' among CRE lenders.

Diversity of response is more likely to be achieved where the market has significant representation from a range of CRE lender types, who themselves are reliant on diversified sources of funding. Diversity of CRE lenders of the same or similar type is clearly better than no diversity at all, but it offers more limited

Outstanding debt secured by UK commercial property by category of lender



Source: The UK Commercial Property Lending Report, published by De Montfort University in May 2013

Recommendation 6

Recommendation: The regulator's function should reflect the important role that can be played in promoting financial system resilience and stability by diversity of lender response (principally through diversity of lender types). Where possible, regulatory action should have regard to levels of diversity and seek to reduce barriers to entry, particularly for different types of lender.

Aim: To promote diversity of lenders in CRE sufficient to protect/cushion the market from a change in strategy by any individual or a group of lenders.

To encourage a regulatory focus on the constitution of the CRE lending market, which can act as an additional indicator of market behaviours and the drivers of participation in that market of different types of lender.

Issues: The Group appreciates that positive regulatory intervention to promote diversity would be both culturally and practically very difficult. However, monitoring the constitution of the market, with a sense of what looks healthy or not, would add value in regulatory terms.

Diversity of lender type is not the solution on its own, as it does not always ensure diversity of lender response. For example, the UK CRE lending market became markedly less concentrated in 2006 and 2007 as debt capital poured in from all kinds of sources (just as equity capital did), before taking flight when the market collapsed, worsening the plight of regulated UK lenders. It is therefore important to monitor and understand both the timing and the nature of new lenders entering the market and their likely response to a CRE crash.

assurance that they will not respond in a similar manner, and at a similar point in time, to stress in their sector or the economy overall. In a market that has diversity of response, in the event of a sector of the market ceasing to offer new CRE loans, a continuing flow of credit from a significant class of other lenders (presumably able to access alternative sources of funding) would support liquidity and investment activity, helping both those wanting to reduce exposure and the real estate market itself.

It would therefore seem worthwhile to encourage genuine diversification of lender response, principally through diversity of lender types. Indeed, limited diversification of lender types may be an indicator that one type of lender (comprising those with the lowest cost of capital, highest use of leverage or greatest risk appetite) is pricing others out of the market – something which should ring warning bells that a bubble may be developing.

(ii) Governors more effective than switches

A preference for sensitive, graduated intervention over the intermittent use of blunt instruments runs through all the Group's recommendations. This approach is particularly important when it comes to the way the regulatory framework responds to information about the CRE cycle.

Predicting reliably as to when a property market crash will happen is impossible. If a bubble is irrational overvaluation then there is no rational way to predict when it will burst. Rather than trying to do so in order to make a surgical intervention at the right moment, a better approach is to use market data to determine when market values have moved into above their whole-cycle average, and to intervene thereafter in a graduated way so as to reduce the likelihood that the bubble will overinflate. Intervention should seek to restrain CRE lending by key financial market participants, including through an increased focus on the sufficiency of their capital buffers to withstand a correction.

Recommendation 7

Recommendation: Regulators should use regulatory governors (including the application of sectoral and cyclical capital buffers) that are increasingly applied as the CRE market rises above its full cycle average, irrespective of views about whether a CRE market crash is anticipated or considered unlikely.

Specific indicators of factors which have been relevant in previous CRE crashes should trigger a presumption of regulatory action, and absent that an explanation.

Aim: To ensure the economy is positioned to manage a CRE market crash at any time when objective criteria indicate that one is possible, irrespective of subjective perceptions of its likelihood.

Issues: A balance needs to be struck between the benefits of automated governors and the need for judgment to be applied – but by their very nature, governors are much better suited to an automatic regime than on/off switches and other blunt instruments.

Automated intervention has at least three benefits:

- It maximises certainty and predictability for market participants;
- It obviates the risk to markets of policy signalling; and
- It minimises the risk that a regulatory 'cycle' synchronised with the market cycle results in a belief that "it's different this time".

Against this, regulatory actions need to reflect all circumstances, including many which cannot be factored in advance into metrics.

Good, real-time information and analysis is essential to enable regulators (as well as other market participants) to understand when the market is above its whole-cycle average, and regulators could then use a series of triggers for increasingly laying on market restraining measures to dampen an overheating market. Governors that increasingly restrain the market in this way would in the Group's view be both less distortive and more effective than simple on/off switches, fixed caps or thresholds and similar blunt instruments. These risk over-distortion of the market and may themselves prompt the crisis they seek to avoid if applied at the wrong time. The use of governors has the added advantage that no absolute bubble/no bubble, intervene/don't intervene decision needs to be taken.

F. THE REGIONAL AND SMALL LOAN CHALLENGE

The potential for multiple lenders to operate outside the principal CRE markets is limited as there is often insufficient density of lending opportunity for lenders to justify employing local presence or local expertise. Consequently there can be very limited lender competition, and in market downturns potentially no CRE debt financing available at all.

The all-in cost of providing, monitoring and recovering small CRE loans (particularly those not in the principal markets) is believed to be high, such that profit margins are small (if positive) and risk-based pricing would potentially lead to increased margin for borrowers.

A solution needs to be found to facilitate a more consistent and diversified flow of sustainably priced credit to regional CRE markets and smaller CRE borrowers and assets across the cycle. The problem is essentially a subset of the broader policy challenge around providing finance to smaller businesses and rebalancing the economy. The solution is likely to involve some form of aggregation and standardisation mechanisms to:

- Allow efficiencies of scale, reducing the cost of responsible loan origination sufficiently to allow it to be priced on a basis that both recognises the risk of loss and remains affordable for borrowers; and
- Facilitate distribution of risk throughout the system.

While the Group has not yet identified a specific recommendation that solves this challenge, and does not create others, the concept of a mechanism which provides an efficient bridge between diverse small CRE borrowers and well-financed lenders with appetite is likely to have some of the following features:

- Efficient local origination expertise; likely placing loans ultimately on behalf of multiple lenders and in some way regulated to ensure minimum standards are maintained. This might, for example, include brokers (although it is recognised that experience in the US raises important questions about whether this would be desirable), or local branches of high street banks;
- Standardisation of small/regional CRE loan criteria and documentation to enable lenders to understand the risks arising from and management of a portfolio of such loans. Recommendation 1 (Database of CRE loans), would support this;
- Loan aggregation, without loss of understanding of the features of individual loans so portfolio risk can be easily understood and monitored;
- Loan managers, who may be different from originators or ultimate lenders. Such managers, to be effective, should have increased powers and responsibilities compared to today's CMBS special servicers, including the power to negotiate and bind lenders, to substitute lenders etc, so their legal duties would need to reflect this;
- Specialist lenders who hold lending capacity but do not necessarily originate or manage their loans, with access to capital raised or allocated for that specific purpose. These could be any equity provider, including pension/life companies, or new vehicles such as mortgage REITS (public and private); and
- A continuing role for UK-regulated lenders as substantial contributors to the origination of regional and smaller ticket CRE lending.

Appendix: The Real Estate Finance Group

1. CONSTITUTION OF THE REAL ESTATE FINANCE GROUP

The Group has no formal constitution, being a group formed by individuals acting in their personal capacity with the objective of delivering, unconstrained, their best recommendations. The Group comprises a Review Group and six separate work streams (each with its own members) selected to ensure representation from a spectrum of, and for their knowledge of and expertise in, the real estate finance market, supported by a Support Group. The Group is grateful for funding that has been made available by the IPF to support its work, on terms that allow the Group to retain full discretion and editorial control over its recommendations.

REVIEW GROUP

Name	*Organisation*
Nick Scarles (Chairman)	Grosvenor Group Limited
Peter Cosmetatos (Secretariat)	CRE Finance Council Europe
Michael Brodtman	CBRE
Phil Clark	Kames Capital Plc
Dr Ian Cullen	IPD
John Gellatly	Aviva Investors
Ian Marcus	Ian Marcus Consultants Limited
Marc Mogull	Benson Elliot Capital Management
Max Sinclair	Wells Fargo Bank International
Shirley Smith	Consultant
Jonathan Thompson	Argent Group
Matthew Webster	HSBC Bank plc

ADDITIONAL PEOPLE ON WORKSTREAMS

Name	*Organisation*
John Barakat	M&G
Dr Richard Barkham	Grosvenor Group Limited
Dr Neil Blake	CBRE
Sue Clayton	CBRE
Peter Denton	Starwood Capital Group
Sue Forster	Investment Property Forum
Dr Benedikt Kiesl	Hypothekenbank Frankfurt
Kevin Sale	Aviva
Isabelle Scemama	AXA Real Estate

SUPPORT GROUP

Name	*Organisation*
Douglas Marvin	KPMG LLP
Mark Peachey	The British Land Company Plc

The Group has benefitted from the attendance at some of its meetings by an individual from the Bank of England in order to provide technical support to the Group.

2. REMIT OF THE GROUP

The remit that the Group set itself at the outset is as follows:

"To consider and produce a vision for the real estate debt finance market in the UK, which meets the objective of ensuring an attractive, efficient and stable market, in the timeframe of the next cycle."

Vision: Covers the nature and balance of participants in the market, the nature of their returns, the categories of the market in which they operate, the objectives of the regulatory framework affecting the market, and the broad nature, balance and types of debt finance available.

Real estate: UK commercial (i.e. not residential) real estate as might be determined investible by general real estate investors, therefore now including student accommodation, leisure and healthcare, but not other specialty asset types (such as infrastructure, offshore, mineral extraction, generation etc).

Debt finance: All debt finance, including hybrid, other than (in economic terms) pure equity, regardless of the nature or location of the lender.

Attractive: Ensures a balance of risk and reward, set at a level which encourages active participation throughout the market cycle.

Efficient: Market operates effectively and with transparency, with barriers to entry set at justifiable levels, and which encourages new participants into the sector.

Stable: The market mechanisms and regulatory processes provide a governor that increasingly discourages lending as, not after, values and aggregate lending rise above trend levels, encourages lending when markets fall below trend and is devoid of perverse incentives that fuel boom and bust. The market, and each relevant segment of it, is not over reliant upon a few lenders or lender types – diversification in almost every sense.

CMBS principal loss analysis for bonds initially rated AAA (Barclays Research)

According to Barclays European ABS database, excluding unfunded super senior swaps in synthetic transactions, €280bn (€ equivalent for non-€ bonds) European CMBS has been issued since September 1996 (364 transactions). As per March 2014, approximately €82bn remain outstanding.

In total, €171bn of historical European CMBS issuance was rated AAA by Fitch, Moody's or S&P (490 classes in 314 transactions); ie, 61% of European CMBS issuance was initially rated AAA by at least one rating agency. Of these *initially* AAA-rated European CMBS, €38.6bn is still outstanding as per March 2014 (182 classes in 119 transactions).

- Since 1996 77% of AAA-rated principal has been repaid to investors
- Six initially AAA-rated classes in four transactions suffered a principal loss. In total, realised principal loss to date is €350mn or 0.2% of the initially AAA-rated principal balance.
- Considering the loss cases only, principal loss severities of the affected tranches range from 0.4% to 97%.

Class	Sub-sector	Principal outstanding at issuance (EUR)	Principal repayment	Principal loss	Loss severity
EPICP INDU A	UK single borrower/ industrial properties/synthetic	€461.4mn	€344.1mn	€117.3mn	25.4%
EPICP INDU B	UK single borrower/ industrial properties/synthetic	€75.2mn	€2.1mn	€73.1mn	97.2%
EPICP INDU C	UK single borrower/ industrial properties/synthetic	€29.8mn	€0.8mn	€29.0mn	97.2%
REC 6 A	UK single borrower/ secondary mixed-use property portfolio	€187.4mn	€69.5mn	€117.9mn	62.9%
OPERA UNI A	Dutch single borrower/ secondary offices	€656.0mn	€439.4mn*	€2.5mn*	0.4%
PROMI 2	UK multi-borrower/ secondary mixed-use property portfolio/ synthetic	€541.4mn	€210.8mn**	€7.1mn	1.3%

Source: Barclays Research. Notes: * additional EUR214.8mn "paid" via new bonds (Utrecht Funding); EUR2.5mn loss due to restructuring costs; ** bonds remain outstanding

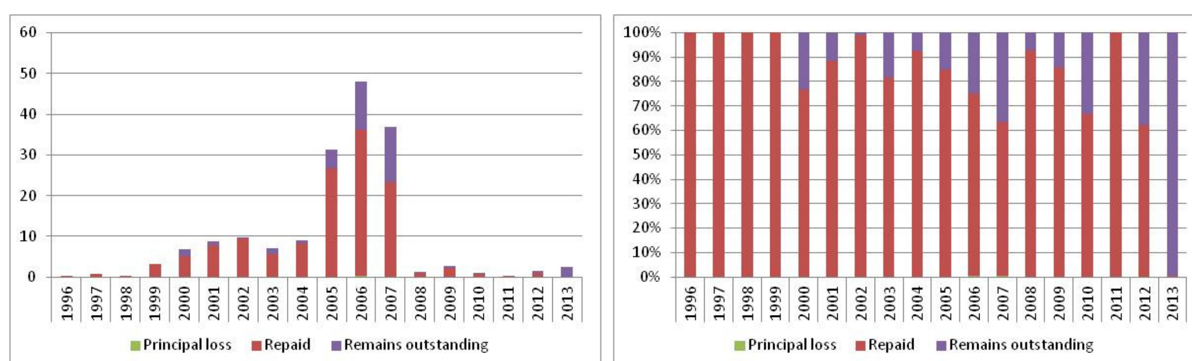
To date, AAA loss cases remain isolated cases; noteworthy is:

- The high principal loss rate for EPICP B and C is due to their subordinated nature (they were not senior ranking in the capital structure).
- EPICP INDU and PROMI 2 are/were synthetic CMBS transactions and the servicer (which also is the credit protection buyer) chose to sell the assets relatively quickly. In a true sale transaction, the loans would have been likely restructured, potentially resulting in lower loss severities.
- OPERA UNI defaulted at its CMBS maturity date, resulting in a debt exchange and "fire sale of the assets". A different special servicer might have sold the properties earlier for a better price and/or aimed to restructure the CMBS before bond maturity.

- REC 6: the transaction did not feature a special servicer and sub-optimal change of control clauses (the junior lender could block the appointment of the special servicer and block enforcement against the borrower).
- The properties securing the four transactions were Dutch and UK secondary properties which were affected by lack of debt finance availability and declining occupational markets. As a result, investors' risk premium to buy such assets increased and the properties fell 40-60% in value since 2007.

Taking non-senior ranking AAA-rated bonds out of the analysis (i.e., EPICP INDU classes B and C), we conclude that principal losses of **senior ranking** initially AAA-rated European CMBS bonds have been EUR240m to date (0.15% of the initial balance).

Historical AAA issuance in European CMBS – performance by vintage (EURbn and %)



Source: Barclays Research

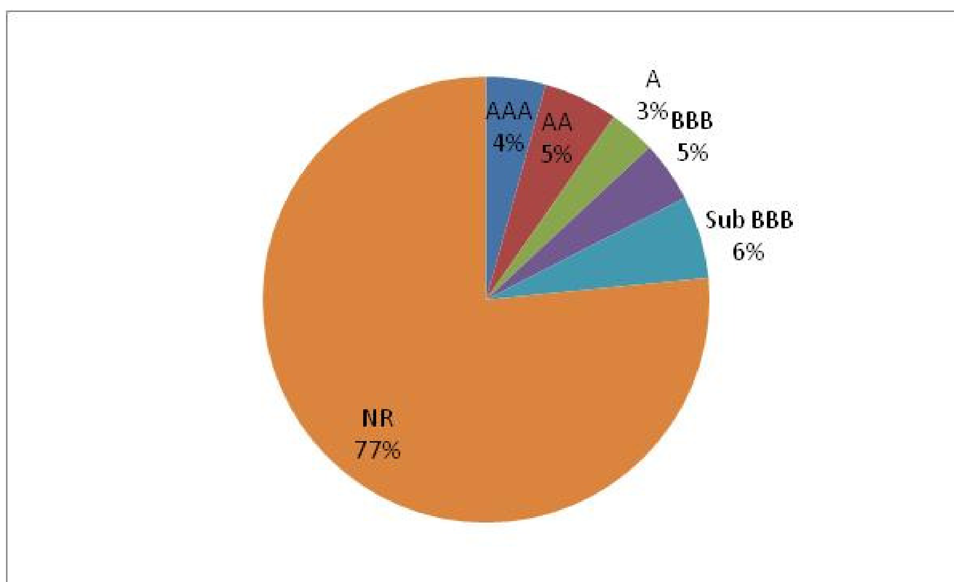
- Most of 2000-04 AAA-rated European CMBS issuance has been repaid; there have been no losses
- More than 60-85% of the 2005-07 AAA European CMBS issuance has been repaid
- Principal loss at AAA level concentrated in 2006-07 vintage (0.5% and 0.3% of initial AAA-rated balance, respectively).

Many European CMBS loans are currently in special servicing and in the process of being worked-out. Barclays expects that potentially, a further 13 initially AAA-rated bonds in ten transactions could suffer an ultimate principal loss. Hence, through the real estate cycle 20 initially AAA-rated European CMBS bonds could become impaired.

All said, principal losses at AAA-level are not expected to become a wide-spread issue in European CMBS, despite the very adverse loan performance which was driven by property value declines up to 50%; negative rental development; and a heavily restricting lending market. In Barclay's view, **at AAA-level** European CMBS in nearly all cases performed as expected and subordination protected these bonds from the effects of a very severe commercial real estate downturn.

Rating agencies share this view: while the rating performance of initially rated AAA-bonds was not favourable, currently 40 of the still outstanding initially AAA-rated bonds are rated below investment grade. 13 bonds are rated below single-B, implying that rating agencies deem an ultimate principal loss as **very likely**.

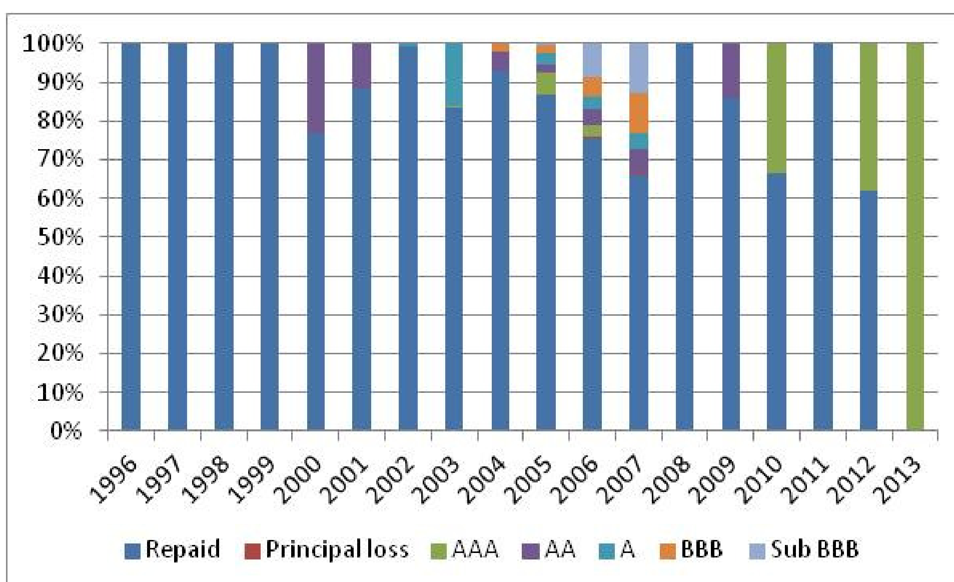
Initially AAA-rated European CMBS – repayment/current rating (if still outstanding)



Source: Fitch, Moody's, S&P, Barclays Research

- Since onset of the European CMBS market (1996), 81% of all initially AAA-rated European CMBS bonds either repaid or remained AAA
- Since onset of the European CMBS market (1996), 94% of all initially AAA-rated European CMBS bonds either repaid or remained investment grade

Initially AAA-rated European CMBS – repayment/current rating by vintage



Source: Fitch, Moody's, S&P, Barclays Research

- Two European CMBS vintages have shown very adverse rating developments: 2006 and 2007.

- Rating performance is worse for the 2007 vintage consisting of transactions issued atthe height of the credit boom: no initially AAA-rated bond from 2007 remained AAA and more than 10% was downgraded to below investment grade.
- Any other European CMBS vintages are not outside the AAA rating-transition norm compared with other asset classes.
- Since 2007, property markets have corrected, lending criteria have become much more stringent and rating agencies have changed their rating methodology to reflect past mistakes. Hence, we expect that future European CMBS transactions perform better than the 20005-07 vintages (in terms of collateral performance and rating).