CREFC Europe response to European Commission's CMU mid-term review 2017

A. Financing for innovation, start-ups and non-listed companies

Are there additional actions that can contribute to fostering the financing for innovation, start-ups and non-listed companies? Yes.

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

It is important to promote a diverse, resilient and responsible commercial real estate (CRE) finance sector to provide a sustainable flow of credit across the business cycle to CRE businesses. CRE businesses and the CRE sector (including provision of finance) are essential to the real economy and especially SMEs, because they provide the premises that start-ups and non-listed companies need to be able to rent in order to conduct their activities. A CRE finance market that is too reliant on one source of capital (such as banks) is likely to provide a limited range of financial products, and is likely to be cyclical, constraining credit supply when the economy needs it most.

Regard should be had to the 2014 report "A Vision for Real Estate Finance in the UK" (produced by the independent UK industry Real Estate Finance Group and available at http://www.ipf.org.uk/industry-involvement/publications/a-vision-for-real-estate-finance-in-the-uk.html) and to the ESRB's report on Commercial Real Estate and Financial Stability and Recommendation on closing real estate data gaps. Among other things, the Vision report highlights the importance of consistent, accurate and timely data on CRE lending (subsequently also recognised by the ESRB), and the need to understand the CRE cycle and its implications for risk management by lending institutions and for macroprudential regulation as a whole (a point that European regulators appear not yet to appreciate).

Achieving a recovery in European securitisation markets also has an important role to play specifically in the CRE context, for one important reason. Post-crisis banking regulation, including the move to higher risk weightings (as most clearly seen in the UK market through the broad imposition of 'slotting' on the major domestic banks) appears in many cases to have reduced banks' appetite for holding CRE exposures on their balance sheets. That is not necessarily a bad thing, provided credit continues to be available to the CRE economy as a whole.

For medium and larger ticket CRE loans, banks and non-bank lenders can both compete and collaborate, with many loans 'shared' across a number of balance sheets through distribution in the syndication market. Data are scarce, but there are grounds for concern regarding the availability of smaller CRE loans. On the whole, it is only domestic banks that have the origination platforms to write such loans - but in the absence of effective securitisation markets, such loans are not easy to distribute, as they are too small for the syndication market. If banks are unwilling to retain them on balance sheet and cannot easily distribute them, will they continue to devote the resources necessary to originating such loans?

Despite a series of submissions we have made, the proposals on simple, transparent and standardised (STS) securitisation seem set to exclude CRE debt entirely - a move that runs completely counter to the promotion of stable, resilient and diverse CRE finance markets. Our summary of the issues on 'qualifying' securitisation and CRE debt is set out in a short policy paper submitted as part of this response. Further, the capital charges associated with securitisation exposures (especially for "Type 2" securitisation like commercial mortgage-backed securities or CMBS) under Solvency II are so penal as to rule out any significant interest from perhaps the most natural investing market for such exposures. It is vital that these capital charges are reconsidered - and reduced - in the context of the forthcoming Solvency II review.

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

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

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

As regards the role that public debt markets can play in improving access to credit for companies, we would reiterate the points made above (and in numerous other submissions) about securitisation markets and commercial real estate (CRE) debt. CRE loans are a very different product than securitisable retail consumer products like residential mortgages, credit card or auto loans. They are fundamentally heterogeneous, credit exposure is to tenants rather than to borrowers (to whom there is normally no meaningful recourse) and a certain amount of investor expertise is advisable.

Institutions tend to prefer commercial mortgage-backed securities (CMBS) with a very small number of loans and (corporate) borrowers (at the extreme, so-called single asset, single borrower (SASB) CMBS), because they can be analysed much more easily than securitisations with, say, 10, 20 or 30 assets and borrowers. A securitised single borrower portfolio is also likely to provide cross-collateralisation, whereas a securitisation comprising 20 or 30 unconnected borrowers will not. The statistical analytical approach on which investors in retail securitisations rely is largely irrelevant in this context.

In an established CMBS market such as exists in the United States, CRE loans may become sufficiently standardised, to suit the appetite of a consistent investor base, as to allow large-scale ‘conduit’ securitisation, where granular portfolios of CRE loans can be securitised. The emergence of such a market in Europe could signal a step change in the availability of credit to CRE businesses and investment in the built environment – especially in the face of reducing bank balance sheet availability for CRE exposures.

If Europe is to benefit from such capital markets, policymakers will have to make some accommodation for CMBS in the planned STS framework, and (even more importantly) abolish the extraordinarily penal capital charges for CMBS under the Solvency II framework (which are higher than for ownership of actual buildings).

As regards the “tax distortions” that are alleged to favour debt over equity, it is important that policymakers understand one point. When the sponsor/owner of a business or asset considers whether and in what proportions to use equity or debt in making its own investment, the difference in tax treatment is plainly important and arguably distortive. However, the choice between selling an ownership share in a business so as to share profits with the new investor, on the one hand, and borrowing at a fixed rate of interest in order to make one’s own equity investment go further is a fundamental one, in which tax is not likely ever to be a primary driver. It is entirely appropriate that the cost of financing genuine third party debt should be tax deductible (as are other business expenses like payroll, rent and the purchase of raw materials), while the extraction of profits is not. Policymakers would do well to remember this fundamental point.

C. Investing for long term, infrastructure and sustainable investment

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

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

Policymakers should not treat “long-term investment” as referring more or less exclusively to infrastructure, as CMU policy papers often imply. Real estate – whether in the form of housing stock or in that of the commercial buildings (offices, shops, leisure facilities, etc.) that form the heart of our towns and cities – is also a long-term business.

There is of course a history of short-term, speculative buying, developing and selling of land and buildings, as some see opportunities for large short-term gains in this highly cyclical market. But that is only one part of the story. For the institutions directing hundreds of billions of euros into real estate, the primary driver

is long-term secure rental income (with characteristics that offer diversification benefits beside mainstream equities and fixed income investments). Even those participating in the market in a more speculative way are contributing to the liquidity and efficiency of a fundamentally, inherently long-term asset class comprising the buildings without which neither business nor society could function. The time and the high tax and other frictional costs involved in transacting real estate, compared to other investment asset classes such as equities or bonds, should not be forgotten. Speculative transactions cannot be entered into lightly when they take weeks or months to complete and carry material costs in terms of transaction taxes and advisory fees.

The fact that buildings are a depreciating asset class requiring periodic capital expenditure and labour to maintain and enhance them makes real estate investment a relatively active business, and one that contributes to the real economy on an ongoing basis as people are employed not only to manage but also to refurbish, renew and retrofit buildings.

Real estate debt needs to be seen in the light of the nature of real estate as a long-term investment asset class that should be remembered alongside infrastructure. Debt makes much real estate investment, development and transactional activity possible, thus supporting long-term investment. It is also a long-term investment asset in its own right. Debt is less illiquid than bricks and mortar (especially debt in bond format), but it remains a relatively long-term asset that generates a long-term income stream for investors. Our comments elsewhere in these submissions about the importance of reviving commercial mortgage-backed securities (CMBS) and the CRE debt securitisation market are also relevant in the context of this question.

D. Fostering retail investment and innovation

Are there additional actions that can contribute to fostering retail investment? Don’t know / no opinion / not relevant.

E. Strengthening banking capacity to support the wider economy

Are there additional actions that can contribute to strengthening banking capacity to support the wider economy? Yes.

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

It is important to strike the right balance in banking regulation between building appropriate resilience without compromising the sector’s ability to provide a suitable flow of credit to the economy. The controversy and uncertainty surrounding the final elements of the Basel III framework (including in relation to the treatment of specialised lending exposures such as real estate, as well as the use of output floors generally) is understandable but troubling: the uncertainty it creates is not helpful for business, particularly given the long-term nature and relatively illiquid nature of most real estate exposures.

It is a little surprising that the consultation paper discusses securitisation principally in the context of “strengthening banking capacity”, because securitisation (unlike covered bonds, for example) is a risk transfer mechanism that enables banks to adopt an intermediary role in the supply of credit from non-bank sources of capital to businesses and households in the real economy. Securitisation therefore has a far broader and more fundamental role to play in the economy than merely “strengthening bank capacity”. In the context of commercial real estate (CRE), two specific points need to be made.

First, with reducing appetite for CRE exposures on bank balance sheets (not least because of rising regulatory costs), it is critically important that a broad range of distribution channels are available, to complement the growing role of non-bank lenders alongside banks. Especially important in this context is the recovery of commercial mortgage-backed securities (CMBS), hitherto effectively frozen out by penal capital charges under Solvency II and inappropriate criteria proposed for STS securitisation.

In particular, the economy needs CMBS because there is currently no alternative mechanism for the aggregation and distribution of smaller ticket European CRE loans by banks. It is generally only domestic banks that have the local presence and infrastructure required to underwrite and originate such loans. To the extent they do not wish to hold them on balance sheet, covered bonds do not provide a solution (exposures remain on balance sheet), and neither does the active and liquid syndication market (it only works for large loans). Policymakers have a responsibility to work with the industry to nurture CMBS markets, specifically, to health. Otherwise, credit flow to CRE SMEs and more generally investment in the built environment of smaller towns and cities will almost certainly suffer.

Secondly, and more generally, an independent UK industry group published a report (also referred to in an earlier response to this consultation) in May 2014 called "A Vision for Real Estate Finance in the UK" (available at http://www.ipf.org.uk/industry-involvement/publications/a-vision-for-real-estate-finance-in-the-uk.html). The aim of that report was to recommend ways in which the banking and wider financial system might be made more resilient to the CRE cycle – to ensure, in short, that the lessons of the global financial crisis did not go unlearned as had happened after previous financial crises linked to the CRE cycle.

Two key recommendations are actively being developed by the industry, with encouragement from the Bank of England: the creation of a loan database that would provide regulators, supervisors and market participants and observers with meaningful and timely information about the market; and the development of a long-term value metric for collateral that could be used instead of (volatile, inherently pro-cyclical) market value in loan-to-value (LTV) ratios for the purposes of lender risk management.

Mortgage lending value (which is familiar to European policymakers) is one of the long-term value methodologies under consideration, but it is by no means the only one, and neither does it seem to be the best one at this stage. European policymakers should be open to exploring how CRD/CRR frameworks and supervisory regimes might make use of the outcomes of this work. There are fundamental problems with the current reliance on simple, market value-based LTV – including under 'slotting' and for the purposes of the proposed revised Standardised Approach under Basel III – and Europe should work with industry experts and representative bodies to understand and address them.

F. Facilitating cross-border investment

Are there additional actions that can contribute to facilitating cross-border investment? Yes.

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

Many of the points made earlier in this response also apply in the context of this question. We do not have additional suggestions.