<table>
<tr><td colspan="2">Comments Template on
Call for Evidence
Request by the European Commission to EIOPA for Technical Advice on the treatment of unlisted equity and debt without an ECAI rating in the standard formula</td><td>Deadline
24 May 2017
23:59 CET</td></tr>
<tr><td>Name of Company:</td><td colspan="2">Commercial Real Estate Finance Council (CREFC) Europe</td></tr>
<tr><td>Disclosure of comments:</td><td>Please indicate if your comments should be treated as confidential:</td><td><s>Confidential/</s>Public</td></tr>
<tr><td></td><td>Please follow the following instructions for filling in the template:
⇨ <u>Do not change the numbering</u> in the column “reference”; if you change numbering, your comment cannot be processed by our IT tool
⇨ Leave the last column <u>empty</u>.
⇨ Please fill in your comment in the relevant row. If you have <u>no comment</u> on a paragraph or a cell, keep the row <u>empty</u>.
⇨ Our IT tool does not allow processing of comments which do not refer to the specific numbers below.
Please send the completed template, <u>in Word Format</u>, to CP-17-003@eiopa.europa.eu
Our IT tool does not allow processing of any other formats.
The numbering of the questions refers to the discussion paper on the review of specific items in the Solvency II Delegated Regulation.</td><td></td></tr>
<tr><td>Reference</td><td colspan="2">Comment</td></tr>
<tr><td>General Comment</td><td>As the industry association for European commercial real estate (CRE) debt markets, we are pleased to have the opportunity to respond to this call for evidence. Our comments relate specifically to unrated CRE debt (in the context of CRE debt investment more generally), as that is our area of expertise.</td><td></td></tr>
</table>

	Problems with the existing capital framework under the standard formula The existing SCR calibrations in the standard formula have created a highly distorted playing field for different forms of exposure to CRE generally, and to CRE debt in particular. There are two fundamental problems. 1) **CRE lending is collateralised and non-recourse.** First, the existing framework appears to misunderstand the nature of CRE lending as a collateralised investment where the lender's rights are against the asset and the cash flows it can generate (which are typically substantially predictable, but may be substantially uncertain), and not against any borrower/debtor with assets or activities besides ownership of the asset. As well as ignoring reality, this conflicts with the approach in banking regulation under Basel and CRD/CRR, where the collateral-based nature of CRE lending is recognised and reflected in relevant rules. Both the Basel framework and the European implementing rules recognise the importance and value of property collateral, linking capital charges to criteria relating to the property collateral. Both have separate definitions, carrying higher capital charges, that can be used to deal with land acquisition, construction and development loans, where predictable cash flows are missing ("high volatility commercial real estate" under Basel, "speculative immovable property financing" under EU rules). It is not obvious why similar principles should not also be used by the Solvency II standard formula. In any event, Solvency II should recognise the fundamental difference between unsecured, full recourse corporate lending, and secured non-recourse CRE lending. 2) **Internal incoherence of standard formula.** Secondly, the standard formula is internally incoherent as regards different forms of CRE and CRE debt exposure. The capital charges for investments in unrated CRE loans are much lower than those for investments in CRE. That makes sense from a credit perspective, as the owner of a building will always suffer a loss before a lender against that building. However, the capital charges that apply to investments in CRE loans that have been securitised (i.e. CMBS) are unjustifiably high, creating a huge distortion in the market that may lead to reduced transparency and systemic risk build-up in CRE debt markets. The capital charges for securitised CRE loans (commercial mortgage	

backed securities or CMBS) are much higher, even for AAA-rated bonds, not only than the capital charges for identical unsecuritised CRE loans, but also (for any duration greater than two years) than the capital charges for ownership of the underlying CRE collateral.

From a credit perspective, this is quite bizarre. The owner of the building will always suffer a loss before a lender with security over the building, as the owner's equity investment will be lost before the lender loses money. Equally, an investor in an unrated loan secured on the building will lose money before an investor in the most senior (AA or AAA rated) tranche of a CMBS underpinned by that loan (other, less senior tranches underpinned by the same loan would lose money first).

A simple example is illustrative: consider a CRE lender that chooses to arrange a rated, tranched CMBS of its loan and to retain all the bonds, instead of simply retaining the unsecuritised CRE loan. The capital treatment would increase dramatically, despite the fact that the loan would, as a result of securitisation, have interest rate hedging, a liquidity facility, an expert independent servicer, at least two independent credit ratings and significantly improved secondary market tradability. How can such discrimination between different ways of holding the same underlying exposure be justified?

The credit analysis is critically important in the context of CRE loans, which differ fundamentally from corporate debt. The performance of unsecured corporate debt exposures depends on the ability of the debtor to raise new equity if required to service and repay the debt; if the financial strength of the debtor is sufficient, credit losses should not arise at all (and focusing on the market risk and pricing volatility of the exposure makes sense).

By contrast, a CRE loan typically provides no recourse to (i.e. no rights against or access to) the wider business or assets of the debtor: the lender's focus is the CRE collateral, which is typically owned by a single-purpose vehicle with no other assets or activities (that entity is the borrower). There is typically no obligation on the owner(s) of the borrower (commonly referred to as the sponsor) to support the asset or the borrower if the asset fails to generate the cash flows required to service and repay the loan. Credit losses therefore can and, from time to time (most significantly on a cyclical basis) do, arise. Credit risk would appear a more relevant consideration in determining capital charges for CRE debt exposures than the point in time value of the relevant exposure.

The enormous difference in treatment between unrated CRE loans on the one hand and identical loans that have been securitised also makes little sense from a market risk perspective: CMBS may have demonstrated significant price volatility over the last decade or so, but that is a function of the fact that there is a relatively liquid secondary market in CMBS. Price volatility may appear lower in CRE and CRE loans, but that is because these are far less liquid markets than the market in securitised public debt.

Consequences of a distorted capital framework under the standard formula

This distorted capital framework for CRE debt investments has inevitably distorted investment by European insurers using the standard formula. The regulations have greatly complicated any recovery in European CMBS markets, and driven affected insurers to invest in CRE loans rather than CMBS, by setting up loan originating businesses, entering the loan syndication market, or investing through segregated accounts or pooled funds managed by third party managers. In the process, both the transparency and the liquidity of Europe's CRE debt markets have been greatly reduced, to the detriment of almost all participants in these markets, including insurers.

At the same time, the role of external ratings has diminished, as CRE loans are typically not externally rated, whereas securitised CRE loans (i.e. CMBS) are typically externally rated. Regulators may be tempted to see this as a welcome reduction in the over-reliance on external ratings, but it is worth asking what replaces the analysis discipline such ratings (imperfect though they may be) can provide. It is not obvious how the resulting market is safer, either for individual firms and their policyholders, or at a systemic level.

STS and non-STS securitisation

Unfortunately, it seems likely that the criteria being developed for simple, transparent and standardised (STS) securitisation will be very difficult for any CMBS transaction, however low risk and sensibly structured, to qualify. As a result, the calibrations for non-STS securitisations under the Solvency II standard formula will be very important if we are to bring greater transparency, liquidity and safety to European CRE debt markets and protect the position of insurers within them.

CRE as a specialist market

CRE is undoubtedly a specialist market, and those lending into it should (especially if they are systemically significant) understand its characteristics generally and its cyclical dynamics in particular. Whereas an equity investor can balance losses on some investments with profits on others, lenders have only a limited and predetermined upside, and are often tempted to increase exposure at the worst point in the cycle. In today's chronically low interest rate and low yield environment, some less knowledgeable investors may be attracted by the returns CRE debt can offer without understanding the associated risks. But that does not mean regulation should create artificial barriers to investment that distort investment decisions, product preferences and capital flows.

An independent UK industry initiative produced a report, A Vision for Real Estate Finance in the UK, published in May 2014, with a series of recommendations for a more informed, strategic and holistic approach to the regulation and safe operation of CRE debt markets. Efforts to take

	forward two of those recommendations – for the collection of consistent, loan-level data across the market and for the development of long-term collateral value metrics to assist risk management – are ongoing, with support from the Bank of England. A third recommendation encourages regulators to promote diversity of supply in CRE debt markets, with insurers having a potentially crucial role to play in providing longer-term and fixed rate credit (including through the securitisation market) and helping diversify risk out of the banking system. Other industry organisations with expertise in CRE debt have published useful materials, including CREFC Europe's November 2012 Market Principles for Issuing European CMBS 2.0; a January 2016 research paper from Bank of America Merrill Lynch ("Which European CRE loans suffered losses and why?"); and an April 2017 special report from Fitch ("UK CRE: Countercyclical Lending Boosts Loan Returns").	
Questions on unrated debt		
Q1	**CRE lending is collateralised and non-recourse** It is important to note that, other than for very small loans and construction loans, most of the commercial real estate (CRE) debt market is a non-recourse, secured lending market. In other words, lender due diligence focuses on the property collateral, not on the borrower (or more relevantly, as the borrower is often a single-purpose vehicle with no other assets or activities, those who stand behind the borrower). In this type of lending, if things go wrong, the lender has rights against the property collateral, but not against any debtor of substance behind it. This is substantively different from corporate credit, where a debtor's financial strength should allow it to raise equity and ensure a default on its debts is avoided. In the context of collateralised CRE lending, it is generally only the CRE collateral and the cash flows it is capable of sustaining that matter. Credit losses can arise if the asset performs significantly worse than	

expected, so analysing CRE debt exposures by reference to credit considerations seems more appropriate than analysing them by reference to market and price volatility.

In CRE lending, the identity, experience, financial strength and 'character' of the borrower is not insignificant – but it is rarely as important as it would be in general corporate lending, and it will be particularly unimportant where minimal specialist asset management is required (for example, for very prime property let on long leases to strong covenant tenants).

Importance of the property cycle

Perhaps even more important is the fact that the focus should not be solely on idiosyncratic (i.e. loan and asset specific) risk, because in past property cycles losses for lenders have often tended to be the result of the market cycle. It is for this reason that the UK industry report mentioned in our general comments, A Vision for Real Estate Finance in the UK, focuses to such a degree on how lending institutions and their regulators can ensure they understand where the market is in the cycle at any given point. It is true that this focus is especially pertinent for lenders providing loans with a relatively short tenor (up to six or even years, say) with little or no scheduled amortization. Insurers providing ten or 20 year loans that are fully amortising could legitimately focus their attention on income sustainability rather than values and underlying property market liquidity. In recent years, we have seen many insurers expand their product range to include shorter term, bank-like loans, so the market cycle would appear relevant.

Accordingly, one initial consideration for determining whether a CRE loan should receive the risk charge for rated debt with credit quality step 1, 2 or 3 is whether the loan is either (a) expected to be wholly or substantially amortised during its term, or (b) if less than substantially amortising during its term, having a sensible loan to cyclically adjusted, or long-term, value (as distinct from any particular loan to market value). A UK working group is researching alternative long-term value methodologies, and the Fitch special report mentioned in our general comments suggests a prudent loan to cyclically corrected value ratio based on a particular methodology. In the absence of more comprehensive and reliable data and analysis at this time, a good starting point for shorter-term, non-amortising loans would be to require the use of a long-term value metric as part of insurer risk assessment and management.

Other suggested criteria

The supervisory "slotting" criteria laid down for banks' specialised lending exposures to income producing real estate under the Basel framework offer a reasonable starting point for credit quality criteria for CRE loans (other than in relation to the property cycle, which is discussed above and which is not adequately addressed by those criteria). Accordingly, other considerations of a more idiosyncratic / asset-specific nature might include the following.

- Loan to value ratio (more generally)
- Debt service or interest cover ratio
- Cash flow analysis (focusing in particular on weighted average lease term, distribution over time of lease expiries and tenant breaks, vacancy rates and lettability of vacant space, comparison of rent currently payable and prevailing market rents)
- Location, specification and condition of the CRE collateral
- Nature of security (whether first ranking, whether including assignment of rents, whether benefitting from sponsor guarantees or other recourse beyond a single-purpose property-owning vehicle, etc.)

Q2	a. In the typical case where recourse is limited to the collateral property and a single-purpose property-owning vehicle, it would not be appropriate to include criteria relating to the financial state of the debtor. b. The quality of covenant protection in the loan documentation is important, and should, as explained in earlier responses, reflect property market/cycle risk as well as asset-specific factors. Financial covenants typically relate to loan to value and debt service or interest coverage. c. As regards transparency offered to investors regarding the debtor, as mentioned at a. above, the more important focus is typically on the asset and asset cash flows, because the borrower/debtor in the commercial real estate (CRE) lending context is commonly a single-purpose vehicle with no other assets or activities. In the private CRE lending market the question of transparency is unlikely to be a major issue, albeit there is only moderate standardization across a very fragmented and diverse sector (again, the collapse of CMBS markets, for which the Solvency II standard SCR framework bears some responsibility, has not helped in this regard). d. Insurers participating in the CRE loan market should have a sufficient degree of expertise, understanding in particular the depreciating nature of CRE and the often credit-linked cyclical nature of CRE markets. e. Insurers lending against construction or development projects should be aware of a range of specific risk factors and considerations in this relatively riskier area of the CRE market.	
Q3	Unfortunately we have not had sufficient time (and in some areas there may be insufficient data) to propose specific levels of risk for the criteria we have suggested above. The obvious starting point would be the rating methodologies used by rating agencies (both the big three and newer	

	and smaller market entrants). We would be happy to bring together appropriate market expertise to help do that.	
Q4	As indicated above, the main source of relatively good quality, consistent data in the commercial real estate (CRE) debt market is the securitisation market (CMBS). We have referred above to research by Fitch and Bank of America Merrill Lynch into the performance of CRE loans and the criteria that are associated with better or worse performance. That research – which is a very good starting point – is based on securitised CRE loans, because data relating to privately held loans (on bank balance sheets or otherwise) are not generally available. The failure of the CMBS market to recover post-crisis (for which the existing Solvency II standard SCR framework is partly responsible) means that the data set is shrinking, and that is unfortunate. As mentioned in our general comments, the Bank of England is encouraging a UK industry initiative to collate loan-level data across the UK CRE market – if such resources were already available, it would be much easier to answer this question.	
Q5	Please see earlier comments. We do not have a methodology per se that we could compare to rating agency methodologies. As a general matter, we believe rating agency methodologies currently in use to be a good basis for assessing commercial real estate (CRE) lending risk. One important feature that they tend to share is a focus on the property cycle and the sustainability of cash flows and collateral value. This focus can sometimes be lost when it is most necessary, i.e. in the last year or two before the peak of the property cycle – not only by rating agencies, but by lending institutions, investors and indeed regulatory authorities.	
Q6	a. Unfortunately we have not had sufficient time to attempt this. However, we would point out that, while the largest property companies privately place bonds, there is a very large commercial real estate (CRE) debt market serving the whole market, including SMEs which involves not bonds but loans, advanced by banks and, increasingly, insurers, fund managers	

	and others. The CRE loan market is private and opaque, and offers very little secondary market liquidity. While it may be dominated by domestic institutions at small ticket sizes, the market in loans of more than EUR25m to EUR30m is quite international. Borrowers are typically single-purpose entities holding one or more CRE assets and borrowing against their collateral on a basis that provides no recourse to the wider business, assets or cash flows of the sponsor group to which the entity belongs. Banks generally prefer to lend for periods of three to five years, often on a floating rate basis (with interest rate hedging). Insurers often prefer longer term and fixed rate loans that can provide liability matching, but have in many cases widened their product range to meet borrower demand for shorter term loans. Fund managers (often managing insurer capital) are a diverse universe pursuing different strategies with different risk preferences spanning from senior, vanilla loans to riskier mezzanine or construction loans. b. We have not been able to attempt to collect this information, but suspect that robust and comparable data simply do not exist beyond the research and analysis we have referenced above looking at securitised CRE loans. c. We have not been able to attempt to collect this information.	
Q7	We have not been able to attempt to collect this information and suspect that robust and comparable data may not exist. Besides CMBS and corporate bonds issued by property companies (which are likely to be rated), insurers can invest in commercial real estate (CRE) debt in the form of loans made directly or through a broker or segregated account; participations in larger loans in the syndication market; and allocations to pooled funds managed by institutional or private investment managers (a universe that pursues a broad range of strategies from the very low risk to much higher risk). Overall, CRE debt exposures in particular will typically be a very small part of the total assets of any insurer. Anecdotally, we suspect the large majority of these	

	exposures are senior (i.e. low risk, high credit quality), with a small proportion, mostly likely invested by the most knowledgeable firms, allocated to higher returning, riskier lending. Diversification within CRE debt markets can be achieved in a number of ways, but given the cyclicality of property markets and the way markets tend to be highly correlated around the peak and trough of the cycle, diversification by internationalising exposures would seem to be an important strategy. However, we have no data about how insurers diversify their CRE lending exposures.	
Q8	As mentioned above, insurers can invest in unrated commercial real estate (CRE) debt in the form of loans made directly or through a broker or segregated account; participations in larger loans in the syndication market; and allocations to pooled funds managed by institutional or private investment managers (a universe that pursues a broad range of strategies from the very low risk to much higher risk). As regards cooperation between banks and insurers, the obvious approach would be for banks to use extensive branch networks, borrower relationships and originating platforms to advance loans that can then be distributed to insurers with the risk/reward appetite but without the infrastructure to do the origination themselves. Most obviously, this can take the form of loans being securitised and insurers buying (rated) CMBS – but despite the obvious benefits (including secondary market liquidity and comparability across different securitised loan pools) that market has never fully taken root in Europe. A similar distribution system could operate at the loan level, but we are not aware of such arrangements being used systematically in the market.	
Q9	We have already mentioned papers by Fitch and Bank of America Merrill Lynch based on commercial real estate (CRE) loans that have been securitised – these are among the best materials we have seen, and we are sure the underlying data could be made available to EIOPA.	

	We would encourage EIOPA to speak to S&P, Moody's, DBRS or Scope Ratings, as well as Fitch, about their CMBS and CRE debt rating methodologies. Broader CRE debt market data are hard to find. We support two initiatives that seek to do this: the De Montfort Commercial Property Lending Report in the UK, and the German Debt Project produced by the International Real Estate Business School at Regensburg University. At a more educational/theoretical level, we would encourage EIOPA to read A Vision for Real Estate Finance in the UK.	
Q10	a. We do not know the answer to this question insofar as it relates to commercial real estate (CRE) debt. b. We do not know the answer to this question insofar as it relates to commercial real estate (CRE) debt.	
Q11	This question does not appear to be particularly relevant in the context of commercial real estate (CRE) debt. This is a form of exposure where the collateral and the cash flows it generates are typically far more important than the financial strength and characteristics of the borrower. Credit risk is generally dependent on the tenants responsible for paying the rent (and their sustainability or replaceability), not on the financial strength of the owner of the property.	
Q12	a. In the context of commercial real estate (CRE) lending, the borrower is usually a single purpose property-owning vehicle with no other assets or activities and the primary focus of credit analysis and due diligence is the collateral. While the lender is typically taking credit risk on the tenants of the CRE collateral (and the asset owner/manager's ability to sustain or replace them), the sponsor group that indirectly owns the property is not unimportant. Depending on the quality of the property, the length of the leases and covenant strength	

	and/or diversity of tenants, the track record and expertise of the sponsor as an asset manager may be very important. Particularly in the context of asset repositioning or construction finance (i.e. where the exposure is not to a stabilised income-producing asset), the sponsor's business plan and ability to execute it and deal with problems that arise could be extremely important. b. See answer to a. above.	
Q13	As a general matter, we consider that regulators have misunderstood and exaggerated the risks associated with a lack of 'skin in the game' in the context of CMBS (we cannot speak to other parts of the securitisation market). While requiring an appropriate degree of risk retention may be reasonable, the central challenge around commercial real estate (CRE) lending is that it can be difficult for lenders to maintain an appropriate focus on the property cycle and to have, and implement, a cycle peak mitigation strategy (non-originating investors, whether in CMBS or in unrated CRE loans, and financial regulators, also face this challenge, and have no better a record in dealing with it). The central importance of the property cycle (compared to the relatively unimportant role of structural features relating to securitisation) can be seen in the fact that loans originated by banks for their own balance sheets as the cycle peaked before the global financial crisis generally performed significantly worse than securitised CRE loans. That experience shows that, while informational asymmetry and misalignment of interests are plainly potential risks that can be aggravated or mitigated by structural and regulatory measures, these were not material factors in the CRE lending market in the last cycle. This Question 13 raises essentially the same question for debt exposures that are not rated by an external credit rating agency, and it needs to be answered with regard to the context described in the preceding paragraphs.	

Against that backdrop, allowing insurers using the standard formula to 'piggyback' on the credit assessment for a private, unrated debt instrument produced by the internal model of a bank or another insurer would worsen the existing distorted regulatory environment that penalises CMBS as compared to unrated CRE loans. In our view, EIOPA should be seeking to move in the opposite direction, reducing the difference in capital treatment under the standard formula between securitised and unsecuritised CRE debt exposures.

More specifically, it is difficult to understand the logic behind this proposal given the stated policy goal of reducing excessive reliance on external ratings. External ratings are not perfect, and we saw in the previous cycle that they are not immune to the effect of the property cycle (which of course also bewitched many balance sheet lenders and financial regulators). But why, as a matter of principle, is it more acceptable to rely on the credit assessment of a bank or another insurer than to rely on the credit assessment of an external credit rating agency? The opposite would strike us as a more plausible proposition.

a. In line with the introductory comments above, the main problem with this proposal is that it would increase an already excessive and unjustifiable difference in capital treatment between rated, securitised CRE debt exposures and unrated, unsecuritised CRE debt exposures, when EIOPA should instead be seeking to reduce that difference. The problems identified in b. and c. below are additional, but secondary, problems.

b. This question seems indistinguishable from the one for rated products, where EIOPA and other regulators have concluded (rightly or wrongly) that excessive reliance on external ratings is to be discouraged and reduced. Our answer would be that insurers, like other investors, must understand that no third party rating (whether produced by an external credit rating agency, a bank or another insurer, or even a regulatory framework) should be relied upon unthinkingly: they remain responsible for satisfying themselves that an

	investment proposed is suitable and an appropriate use of capital having regard to all relevant considerations. c. This question seems indistinguishable from the one in the securitisation context, where a minimum percentage of risk retention is contemplated. Both as a matter of principle and to avoid worsening the already unjustifiable difference in capital treatment between rated, securitised CRE debt exposures and unrated, unsecuritised CRE debt exposures, we would suggest that 'skin in the game' mechanisms that are at least as strict (and probably stricter, for the reasons discussed above) as those applicable to CMBS should apply here.	
Questions on unlisted equities		
Q1		
Q2		
Q3		
Q4		
Q5		
Q6		
Q7		
Q8		
Q9		
Q10		
Q11		
Q12		

	Comments Template on Call for Evidence Request by the European Commission to EIOPA for Technical Advice on the treatment of unlisted equity and debt without an ECAI rating in the standard formula	Deadline 24 May 2017 23:59 CET
Q13		
Q14		
Q15		
Q16		
Q17		
Q18		