CREFC Europe response to joint Bank of England and European Central Bank discussion paper of May 2014: *The case for a better functioning securitisation market in the European Union*

CREFC Europe is grateful for the opportunity to comment on this discussion paper (the **DP**).

CREFC Europe is a trade association promoting a healthy, sustainable and successful commercial real estate (**CRE**) debt market in Europe. Our core membership includes lenders and intermediaries who help connect capital seeking the risk and returns of CRE debt with real estate firms seeking finance. We seek constructive and effective dialogue with non-originating investors, borrowers and regulators in promoting CRE debt markets that support the real economy without compromising financial stability.

Our response to the DP should be seen in that context: we are concerned not with the debt capital markets per se, but with the overall CRE debt ecosystem in the context of the CRE market and the real economy as well as in that of capital investment markets. We believe that commercial mortgage backed securities (**CMBS**) have an important role to play in promoting the health and diversity of that ecosystem, helping to reduce volatility and risks to broader financial markets. Given our membership and expertise, our comments are for the most part focused on CRE and CMBS.

Below, we set out a brief executive summary, followed by some more general comments prompted by the DP. **Appendix 1** provides essential context and background about the role and importance of CRE and CRE debt for Europe's economy and financial stability, without which CMBS cannot be properly understood. Our specific responses to the questions posed by the DP are set out in **Appendix 2**.

Executive summary

We are encouraged by, and support, the DP. We welcome its aims and the pragmatic, balanced and strategic perspective it adopts, as well as the clear, principles-based approach it proposes for differentiating within the securitisation market.

Other, more advanced, work streams seek to identify a privileged 'high quality' part of the securitisation market. We hope that, where appropriate, ways can be found to 'retrofit' definitions developed by other work streams with good ideas emerging from this initiative. We fully appreciate that regulatory harmonisation will not always make sense; but where it does, this more considered process should not be disadvantaged simply because it lags other work streams.

CMBS and CRE are quite different from most other ABS asset classes, and certain principles that may seem obvious for other asset classes do not make sense for CMBS. Most ABS asset classes involve the securitisation of homogeneous, naturally small scale and granular, consumer loan products. By contrast, individual CRE assets (and thus CRE loans) are large scale, inherently heterogeneous and part of a business, rather than consumer, market. A well-functioning European securitisation market for CRE debt (CMBS) is part of the solution to the challenges posed by CRE debt to market participants and financial stability, not part of the problem. Appendix 1 elaborates.

We agree with para 126 of the DP that the aim of principles-based designation of securitisations should be to make the assessment of risks more straightforward, not to provide an opinion on credit or other risks. However, we disagree with some of the proposed principles, most notably the suggestion that receivables should be entirely self-liquidating (para 132). Some degree of refinancing risk is an inherent and very common feature of CRE lending. It is perfectly susceptible to being analysed and evaluated, given appropriate information and expertise (and improving market transparency is a key CREFC Europe aim). Full amortisation is neither reliably effective nor practically achievable in CRE lending markets. There are other, better ways of protecting CMBS from the cyclical tendency in CRE lending markets to under-estimate loan refinancing risk. See further our responses to Q7 and Q18 in Appendix 2.

General comments

Policymakers are faced with a number of competing and contradictory concerns and objectives where securitisation is concerned.

(a) Parts of the ABS market (including some European CMBS) performed poorly during the crisis, and there is an understandable perception that the 'brand' is tarnished and a desire to ensure that the mistakes of the past are not repeated. Securitisation should therefore be **punished**.

(b) There is a growing recognition that the debt capital markets have an essential role to play in supporting the financing of the real economy, stimulating growth and tackling unemployment. 'Real economy' securitisations should therefore be **rehabilitated**.

(c) There is a new sensitivity to financial system stability and resilience, and an awareness that securitisation can help to disperse risk originated within the banking system. Securitisation is to be **encouraged** if it transfers risk out of the banking sector.

(d) Regulatory supervision is being extended to a broader range of financial institutions with economic or potential systemic significance. From that perspective, securitisation might be **dangerous** if it transfers risk into non-bank financial institutions.

These political, economic, macro-prudential and micro-prudential considerations are not easy to reconcile – and striking the right balance is especially difficult where there is political pressure, urgency and imperfect understanding and trust between regulators and industry. We believe that progress has been erratic so far.

In our view, the two most useful objectives that regulators should set for themselves if they wish to encourage the emergence of well-functioning securitisation markets in Europe are:

(a) to ensure that regulated entities that are natural ABS investors, such as insurance firms and pension funds, are not inappropriately disincentivised by their own regulatory rules from investing in ABS; and

(b) to promote, as broadly as possible across the ABS sector, best practice in the way securitisations are designed, structured and sold. Transparency regarding transaction documentation and the features and performance data of the underlying loans and security should be central to this.

We see the balanced, strategic perspective and principles-based approach adopted by the DP as a very positive step towards the second objective (albeit subject to some important comments, discussed below). However, we are concerned that there are few signs of progress so far towards the first objective, and are particularly troubled by the way relevant aspects of Solvency II have evolved (also discussed below).

However, we are concerned that regulators have tended to regard CMBS as an odd and problematic corner of ABS markets, rather than recognising it as an extremely valuable tool for addressing some of the problems of the wider CRE debt market. A revitalised, well-functioning CMBS market in Europe could bring better transparency to more of the CRE debt market, enhancing economic and financial system resilience by improving diversity both in the sources of CRE debt capital, and in the range of CRE debt products available to the CRE industry. In considering CMBS, regulators must understand:

- the particular characteristics of CRE;
- the functional importance of CRE to the real economy and the role of debt alongside equity for the CRE industry;

- where performance is considered (either explicitly or implicitly), the context of the wider, unsecuritised CRE loan market, rather than merely comparison with other ABS asset classes; and
- the implications for financial stability of the structure, composition and depth of the CRE debt market and of the way CRE, credit and regulatory cycles interact.

The volatility and poor performance of CMBS relative to other ABS asset classes during the crisis is no justification for regarding CMBS as a flawed and problematic product. Most of the problems affecting CMBS flowed from the operation of the underlying CRE lending market – and against that benchmark, CMBS did not perform poorly. Aspects of CMBS that might seem problematic viewed from a broader ABS perspective (for example, lack of granularity, or the fact that underlying loans are rarely self-liquidating) are neutral, natural characteristics of a debt product linked to the CRE market.

We firmly believe that CMBS, like the underlying CRE lending market, must be improved, and CREFC Europe is at the heart of industry efforts to achieve that. We need regulators to support those efforts, not stymie them by imposing impracticable and inappropriate conditions when designating a privileged category of securitisations.

We would be delighted to discuss any aspects of our submission with you in greater detail and to support your efforts to improve Europe's securitisation markets in any way we can. Please contact me (details below) in the first instance.

Yours sincerely

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Appendix 1: Introduction to CRE and why CRE debt securitisation matters[1]

CRE in the economy

CRE is a central part of our built environment, without which cities and society as we know them could not exist. It is generally regarded as including not only offices, shops, logistics and industrial space, but also professionally managed rental housing, student accommodation, assisted living, hotels and leisure. According to European Central Bank figures, real estate in all its forms accounted for more than 17% of value added and more than 7% of employment in Europe in 2013.[2] Studies[3] indicate that the commercial property sector alone had a market value of some EUR 5 trillion and directly contributed EUR 285 billion to the European economy in 2011, comprising around 2.5% of the total economy and employing over four million people – making CRE bigger than both Europe's automotive industry and its telecommunications sector.

Commercial property is where we work, shop and relax, and includes rented housing, student housing for the young and assisted living accommodation for the old. It is also a vital enabler of economic activity, capable of supporting or constraining employment and growth. A large and healthy CRE investment market provides incalculable value to the economy by allowing businesses to rent premises flexibly according to their changing needs. Around half of the EU's commercial property is leased by businesses that like the flexibility of renting and are reluctant to commit the capital and management time required by owner-occupation. That allows them to focus on their business and optimise their use of capital, minimising their exposure to the relatively volatile, opaque and cyclical property market. Those who own their premises can use them as collateral, improving their access to finance.

The CRE cycle and capital flows

CRE is by its nature fundamentally long-term, illiquid and capital intensive, at two levels.

- It takes time to build, alter or remove buildings to satisfy the constantly changing needs of businesses and investors. As demand fluctuates with the ebb and flow of broader economic cycles, CRE businesses risk anticipating it incorrectly. The non-fungible nature of CRE, where each building is unique in terms of the combination of its location, purpose, specification and age (and thus value), makes it even harder to anticipate demand accurately.

- Investing money directly into CRE takes much longer than investing in bonds or shares – typically weeks or months rather than minutes. Furthermore, transaction costs are high for CRE, so longer hold periods are generally required before investors can expect to achieve a positive return.

The fact that the supply of bricks and mortar cannot be expected to match either the pace of occupier demand for space or the flow of capital into the sector means that a CRE cycle is inevitable. When rising demand for buildings cannot be met by increased supply, values go up; and reduced demand is reflected in falling values, as buildings cannot suddenly be removed to restrict supply. Judging supply/demand cycles is an essential part of the skillset for CRE businesses and CRE investors: get the timing right, and you can see the value of your assets increase, but get it wrong and you can be stuck

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[1] This section of this submission is substantially derived, but adapted, from the Overview and first Appendix of *A Vision for Real Estate Finance in the UK*, a report published in May 2014 by the Real Estate Finance Group (**REFG**) with the support of the Investment Property Forum (**IPF**). See https://www.ipf.org.uk/home/vision_for_real_estate_finance/default.aspx. CREFC Europe acknowledges the copyright of the REFG and the IPF in the source text.

[2] See http://www.ecb.europa.eu/pub/pdf/mobu/mb201406en.pdf, pages S51 and S54.

[3] See *Real Estate in the Real Economy*, a report by the European Public Real Estate Association (**EPRA**) and the Association for Investors in Non-listed Real Estate Vehicles (**INREV**): http://www.epra.com/media/Real_estate_in_the_real_economy_-_EPRA_INREV_report_1353577808132.PDF.

holding assets no-one wants. The economy benefits most when CRE market participants generally get it right, enabling markets to remain broadly stable: occupiers get the space they want (delivered at the right time and in the right locations), and capital is deployed into the sector at an appropriate pace.

CRE investment is a capital-intensive business with a traditionally significant structural reliance on some element of debt finance. CRE is a depreciating asset class that requires periodic capital investment to maintain marketability for occupiers and investment value. Capital investment may involve wholly new development, redevelopment, adaptation, extension or change of use, refurbishment or modernisation. It is often attractive for CRE businesses to pair equity capital (which demands a high return for the high risk it is willing to tolerate) with debt capital (which is content with lower returns because it takes less risk than the equity).

Various commercial considerations – chiefly associated with the availability and relative cost of raising and holding different forms of capital – influence the extent to which businesses use debt. As a general matter, leverage amplifies risk and (up to a point) returns for the equity invested, because debt is generally a fixed cost, payable before equity returns. If the business fails to generate sufficient returns to meet debt costs, it will fail and the equity investment may be lost. On the other hand, after debt costs are met, all further returns represent a greater proportionate return on the equity invested. In many countries, the differential tax treatment of debt (the cost of which is deductible) and equity (returns on which are not deductible) may incentivise some businesses to use more debt. Other businesses may balk at the risk, financial discipline and operational constraints that debt entails.

Choices around what kind of capital to raise are particularly important in capital intensive industries like CRE, and play out in different ways depending on the context, as well as the strategy and preferences of the CRE business. The risk and return calculation, and the pricing of different kinds of capital, are different depending on the underlying property and the borrower's strategy.[4] Across the industry as a whole, there is generally an important place for debt, but the proportion varies greatly, depending on the owner, the asset, the stage of the building's lifecycle and the market cycle.

Its size as a sector and its characteristics as an investment also make CRE an important asset class for investors. It offers relatively stable and secure long-term returns (represented by rents and capital growth) while routing long-term savings into this important element of the economy's capital stock. In mature markets, income typically accounts for the majority of the total return from CRE over the long term. Income performance is also characterised by low volatility across the cycle (capital returns can be much more volatile).

Within the broader CRE asset class, CRE debt represents a lower risk, lower return option for investors (alongside its function of providing CRE owners with the ability to leverage their own equity investment). The attractions of lending against the security of land and buildings are so obvious that they are sometimes overlooked. As capital returns from CRE are relatively volatile, it is safer to lend against the rental income that CRE generates. However, despite its relative volatility and illiquidity, the underlying capital value of land and buildings is an extremely valuable security that few other forms of lending offer.[5]

CRE lending can be conducted in a safe way based on a sound understanding of CRE asset, portfolio and market risks and appropriate terms and pricing – but it is not always conducted safely. Lenders (both

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[4] For example, the asset may be a speculative or pre-let development project; or the borrower may be seeking to refurbish and/or reposition an asset which it already owns or is acquiring; or the borrower may simply be purchasing a stabilised, income-producing asset. Each of these scenarios will present a very different proposition for a prospective lender.

[5] Lending against development projects (which do not produce income during the construction phase) is not suitable for securitisation and requires a specific skillset, delivering higher returns to reflect the greater risk as compared to lending against income-producing assets.

traditional and new) can be attracted by the ease with which capital can be deployed in CRE debt and the apparent (but illusory) safety of lending into a rising CRE market. Limited barriers to entry and the perception that no specialist expertise is required can lead to substantial CRE finance entering the market with neither local market knowledge nor a proper portfolio-level risk assessment. There is also a temptation for CRE debt investors to focus on lending volumes and required returns, which can be objectively assessed, rather than on risk, the assessment of which is more subjective. The effect is pro-cyclical, with excess liquidity and competition among lenders driving CRE values up and underwriting standards down. It is largely more bullish capitalisation rates, rather than actual earnings, that drive values up as the boom approaches its peak.

It would be a good thing (both for reducing CRE market volatility and for financial stability) for this pro-cyclical feedback loop between CRE and credit cycles to be addressed. It needs to be tackled at the level of the primary CRE lending market, because that is where it arises (and *A Vision for Real Estate Finance in the UK* makes specific recommendations to that end).[6] The securitisation of CRE debt simply allows exposures to be transferred: treating CMBS as if it were responsible for problems in the operation of the underlying CRE lending market would simply concentrate exposures in originating institutions, notably commercial and investment banks.

A side effect of the use of CRE as collateral by non-CRE businesses is that it increases the systemic importance of CRE both to the banking system and to the economy as a whole. As CRE values rise, the equity of businesses in the wider economy increases, improving their access to credit. Conversely when values fall, access to credit is reduced, its cost increases, and the sustainability of existing debt (particularly in the short term) can be compromised. CRE debt markets are especially important to SMEs, which generally have a more limited range of options for accessing finance than larger enterprises.

Historically, the vast majority of European CRE debt has been originated by European (and to a lesser extent overseas) banks. In the last cycle, some of that debt was securitised into CMBS, potentially providing a relatively flexible and liquid way for other investors to gain exposure to CRE debt risk and returns in the secondary market. A reasonably transparent and liquid secondary market is important because most non-bank sources of capital – even those with relevant expertise – lack the infrastructure to originate CRE debt themselves. That is particularly the case outside the major urban centres and for smaller sized loans so, again, is especially important for SMEs in the wider economy.

There are various ways of linking CRE borrowers to non-originating sources of CRE debt, including the syndication market, structured products, covered bonds (where covered bond markets exist) and CMBS. Only covered bonds and CMBS are designed to create two-way secondary liquidity, and only CMBS can do it in a way that takes the risk out of the banking system. But while the CMBS market has effectively delivered those benefits in the US, it has made a more limited contribution to diversifying the sources of European CRE debt.

In Europe, the market share of CMBS was roughly 10% of CRE lending prior to the financial crisis (it was more than double that in the US). Towards the peak of the market in 2006 and 2007 much of the credit risk distributed via CMBS was later revealed to have remained within the banking system. When the crisis began, banks found themselves holding the majority of European CMBS exposure on their balance sheets. It is worth considering why CMBS has not attracted greater participation from 'real money' investors in the past and how their greater involvement could provide a more stable source of capital in the future. This history certainly justifies looking closely at the performance and practices in CMBS –

[6] Notably, Recommendation 4 proposes the use of a cycle-insensitive, long-term value measure in the calculation of LTV ratios for the purposes of lender risk management and (where applicable) capital rules. See the report, referenced in footnote 1, for further details.

and CRE debt markets more generally – and for tackling problems that the crisis highlighted. However, it does not justify regarding CMBS as a fundamentally flawed product.

CRE debt and financial stability

CRE lenders and debt investors cannot make super-profits on some transactions to compensate for losses on others, because their upside is limited to their finance charge. For that reason, lending to CRE businesses (like lending generally) should be a less volatile and risky business than equity investment, particularly for banks and other systemically important financial institutions (**SIFIs**). The supply of CRE debt should respond to demand from those with specialist expertise in CRE, who are willing to take the risk of investing the equity capital at their disposal. CRE risk taken on by SIFIs should be properly understood and priced by those institutions, and reflected in adequate equity reserves in line with appropriate regulatory capital rules. Problems arise if that does not happen.

At the market level, the amplifying effect of debt manifests itself through its pro-cyclical impact. Leveraged investment exacerbates swings in prices and amplifies booms and busts in real estate, in turn exacerbating banking crises. In various countries, substantial cyclical CRE lending by SIFIs – helped by the persistently cyclical nature of regulatory responses – has often resulted in large banking system losses on CRE. In recent years, there has been a structural shift to shorter-term CRE debt prompted by the regulatory framework applicable to banks, as well as the demand for greater operational flexibility from many CRE industry borrowers. As CRE lending volumes are highest in the few years before a crash, a market dominated by three to five year CRE lending is especially vulnerable to large-scale defaults when many loans mature at the worst point in the cycle.[7] Short-term loans are also, of course, effectively impossible to amortise fully during their term.

Three features of CRE debt are crucial to its role in the CRE cycle.

- The speed with which debt capital can flow into or out of CRE dramatically amplifies the CRE cycle. Data[8] show that, while the amount of equity capital invested in CRE in Europe was broadly stable each year in the period 2001-10, the proportion equity comprised in total capital flows into European CRE was around 45% in 2001-04 and 50% in 2008-10, but only 28% in the period 2005-07. Both the rapid growth in CRE prices in the boom and their steep fall in the bust were largely driven by the behaviour of CRE lenders, rather than by equity flows into CRE.

- The majority of lending is advanced during the exuberant phase of the cycle. The optimistic mind-set of the boom informs how market participants value CRE cash flows and perceive the risk of loss, and can even affect the related regulatory capital requirements.[9] Moreover, as the cycle progresses towards its peak, the use of traditional loan-to-value (**LTV**) measures will tend to drive overall lending volumes higher. With insufficient capital built up during the boom, lenders can find themselves very exposed after a crash, with many outstanding loans no longer covered by the value of the property on which they are secured. As the crisis showed, the consequences for the

[7] It can be difficult, in such a scenario, to distinguish between stressed or defaulting loans where the difficulty is temporary and forbearance justified, and cases where the underlying fundamentals of the loan and collateral are weak and enforcement, sale or restructuring may be more appropriate.

[8] See Figure 1 (Drivers of the CRE cycle) in *A Vision for Real Estate Finance in the UK* (referenced in footnote 1).

[9] Historically, regulatory capital frameworks generally either pro-cyclically encouraged banks to move up the risk curve (where capital requirements were not risk-sensitive), or were vulnerable to optimistic interpretation (where capital requirements depended on models or judgment).

financial system, the taxpayer and the economy as a whole can be very damaging when SIFIs find themselves in that position.[10]

- The competitive environment of the boom favours borrowers over lenders in terms of risk-adjusted returns. In theory, both borrowers and lenders take more risk as LTV ratios rise and loan margins fall. However, borrowers will have progressively less equity at risk as the cycle progresses, and are therefore the residual beneficiaries of any cycle-driven mispricing of CRE debt. Such mispricing occurs because competition encourages lenders to reduce the margins they charge, even as rising values increase both their risk of loss and the amount they have at risk. It seems likely that cycle-related pressures increasingly tempt lenders to price loans by reference to their cost of funds (which will be lower late in the financial cycle), rather than on the basis of relevant risk characteristics. This state of affairs suits the more entrepreneurial and risk-taking parts of the property industry, but is unhelpful for financial stability.

The experience of the last few years fits into a long tradition of financial crises linked to the property cycle. For example, Bank of England data show that the UK CRE market has experienced five distinct boom-bust cycles in the last century, characterised by average peak-to-trough price falls of 26%.[11] The impact on the health of the banking system was very clear in the recent crisis. Some of those exposed to the relatively modest part of the European CRE debt market that had been securitised also suffered.

There is an illusory simplicity to CRE lending: assessing and pricing the risk of a secured loan against an income producing physical asset with an inherent capital value is surely a more straightforward matter than lending to most other kinds of business. But CRE lending is a varied universe and can be anything from very risky to very safe. Over many cycles in many countries, neither banks nor their regulators have found effective ways of systematically assessing and managing CRE lending risk. Instead, they tend to go with the cycle, underestimating risk and flooding the CRE market with debt in a boom, and overestimating risk and starving the CRE market of credit after a crash.

Stopping the CRE cycle is neither possible nor necessary to protect financial stability; neither is restricting the attractiveness and viability of risk transmission mechanisms like securitisation. However, strengthening the financial system's ability to weather future CRE booms and busts requires a loosening of the link between the CRE cycle and the two different cycles that feed it:

- the pro-cyclical behaviour of banks and other lenders which feed the boom with loose lending, before exaggerating the bust by starving real estate businesses of credit; and

- the pro-cyclical behaviour of regulators, who tend to grow too relaxed about risk when markets are overheating and risk is objectively greatest, and become excessively risk averse after a crash when credit is most needed to support investment and risk is objectively lower.[12]

Building greater stability and counter-cyclical mechanisms into the financial and regulatory systems to decouple lending and regulatory cycles from the CRE cycle should also help the CRE sector and the wider economy. Rather than exacerbating the cyclical peaks and troughs through alternating excess liquidity and credit drought, lending institutions and their regulatory framework could instead provide a

[10] Again, this issue is not peculiar to CMBS – it relates to the underlying CRE lending market, which is the level at which it needs to be tackled (for example, as recommended by *A Vision for Real Estate Finance in the UK*, referenced in footnote 1).

[11] See http://www.bankofengland.co.uk/publications/Documents/speeches/2013/speech701.pdf. The amplitude of the property cycle is perhaps three times greater than that of the business cycle.

[12] As Andrew Haldane (then Executive Director, Financial Stability) of the Bank of England put it in a speech at the American Economic Association Annual Meeting on 3 January 2014, the "*time-consistency dilemma*" facing macro-prudential regulators "*manifests as a desire to loosen regulation to support today's growth when tightening to counter tomorrow's crisis would be more appropriate*".

more consistent and sustainable flow of credit to CRE across the cycle. Furthermore, as improved stability reduces risk for lenders and borrowers, their required returns should fall, reducing the cost of both debt and equity capital for CRE investors and their customers and increasing investment to support wider economic growth.

Against that backdrop, CMBS should be part of the solution, because it can transmit risk around the financial system, allowing non-originating investors access to CRE debt and facilitating a broader range of loan products than originator balance sheets alone are likely to generate. The performance of CMBS during the crisis needs to be assessed not only relative to other ABS asset classes (which did better than CMBS), but relative to the wider CRE lending market. The most robust data we have seen is 2011 UK data, and indicates default rates of 7% in securitised CRE loans compared to 26% in unsecuritised CRE loans.[13] Looked at in that way, CMBS was one of the many victims of a cyclical fall in underwriting standards. Simpler structures, improved transparency and better documentation can all make future CMBS better – but the fundamental challenges lie in the underlying CRE lending market.

[13] This comparison (presented in Bank of America Merrill Lynch's *European CMBS 2012 Outlook and 2011 Review*, published 12 January 2012) also strongly suggests that poor alignment of interests has not been a factor in the performance of CMBS.

Appendix 2: Detailed responses to specific questions raised by the DP

Motivations
Q1. Do respondents agree with the benefits of a well-functioning securitisation market as outlined in Section2?
Yes, we agree. In particular, a well-functioning securitisation market has a vital role to play in reducing the traditional dominance of banks in the European CRE finance market, in the interests of promoting both capital flows to a critical enabling sector of the real economy, and financial stability. We are still living with the consequences of the fact that CRE finance has been heavily concentrated in the European banking system, where the resulting risks are opaque both for regulators and the market. While greater diversity in CRE loan origination (and indeed in equity ownership) is relatively easy to achieve in core, prime markets with large scale assets, the CRE investment market in smaller assets and regional assets is structurally reliant on domestic banks. A better-functioning CMBS market can improve competition and support financial stability by: (a) allowing non-originating investors to gain exposure not only to more liquid forms of CRE debt, but also, potentially, to smaller scale, SME, and regional parts of the market; (b) freeing CRE businesses (particularly smaller and regional ones) seeking debt from the constraints of the balance sheets and regulatory and commercial preferences of banks as regards the terms and pricing of loans available; (c) dispersing CRE debt risks around the financial system, away from systemically important banks; and (d) increasing CRE debt market transparency, as there is far better information both for the market and for regulators about the public CRE debt market represented by CMBS than there is about the rest of the CRE debt market, which is private and about which very limited good quality data are generally available. It is important to note that the benefits of a well-functioning CMBS market are needed not only at the high quality, low risk end of the market, but also for higher risk, higher return parts of the market. That is true both from the point of view of the real economy (smaller size and regional CRE loans would generally be regarded as higher risk, higher return, but the communities where the relevant CRE is located require investment just as major centres do), and from the point of view of CRE debt investors (who may want a diversified portfolio to include such exposures), and from the point of view of financial stability (do we really want to encourage banks to distribute low risk exposures while retaining higher risk exposures?). Accordingly, while we strongly support a principles-based approach for identifying simple, structurally robust and transparent securitisations, those characteristics should not be confused with risk and credit quality.
Barriers to a well-functioning securitisation market in the EU and economic of securitisation
Q2. After para 82: Do respondents agree with the impediments to and economic concerns of investors that have been identified? Do respondents think that there are any additional impediments to investors, and if so, what are they?
Yes, we agree. We would highlight the dangerously distortive impact that poorly designed regulation can have. For example, as we understand it, the proposed Solvency II regime would impose a total aggregate capital charge on an insurer holding a five year duration AAA CMBS bond of

62.5%, as compared to a charge of 15% for an unrated five year duration whole loan; or less than 4% for a five year duration covered bond; or 25% for direct ownership of the actual real estate; or 39% (listed) or 49% (private) for a non-look-through investment in a company or fund that itself has an equity or debt exposure to the real estate.

The relative position of the safest CMBS bonds in that structure seems to us quite impossible to justify – but the message it sends to insurers seeking CRE and/or CRE debt exposure is very clear: buying CMBS is the worst way to do it. That is despite the liquidity and risk diversification benefits that CMBS can offer insurers as compared to whole loan origination. From a broader investor perspective, taking insurers out of the CMBS market can only reduce the size and liquidity of the market for others, including asset managers without the ability to set up their own origination platforms.

We understand that the risk retention rule raises compliance costs for private funds, which are highly sensitive to expenses, especially in a low interest rate environment. Even these relatively modest costs can skew the risk/reward profile of an asset class and dissuade market participants from investing in a particular type of security.

An additional impediment for investors in ABS (including CMBS) are higher operational requirements compared with other asset classes. This includes due diligence requirements which, while proper in themselves, penalise securitisation on a relative basis when viewed in the round alongside capital charges. Well-informed and sophisticated investors willing to invest in the systems and expertise required are penalised by higher capital charges compared with other asset classes that have lower operational requirements.

On sovereign rating caps, we think that rating agencies are transparent enough that investors usually know what the rating would be absent the cap. However, investors will be penalised for investing in ABS subject to rating caps because capital requirements are based on the capped rating and not on the underlying uncapped rating. In other words, the problem arises because of the regulatory capital rules, not rating caps per se, which rating agencies can explain.

Q3. After para 92: Do respondents agree with the impediments to and economic concerns of issuers that have been identified? Do respondents agree that the infrastructure concerns raised above affect the economics of securitisation? Do respondents think that there are any additional impediments to issuers, and if so, what are they?

Yes, we agree. Higher issuer operational costs for ABS (relative to other funding instruments), as a result of higher transparency requirements etc. (however reasonable and appropriate these may be) are also a consideration.

Q4. After para 94: Do respondents agree that market liquidity may be a barrier to a well-functioning securitisation market?

Yes, we agree. Market liquidity will of course also suffer if many ABS are ineligible for treatment as liquid assets. Higher capital charges and operational requirements for bank trading desks are also likely to increase bid/offer spreads.

The US CMBS market returned due largely to two factors. First, issuers, servicers and investors worked together to make substantive improvements in industry standards and disclosure practices. Secondly, the Federal Reserve Bank of New York established the Term Asset Backed Securities Facility, which injected liquidity back into the system at the weakest point in the cycle. Today, participants in the US generally agree that current CMBS volumes are healthy, though they stand at roughly one third of peak issuance. The industry dialogue and short-term government support

resulted in a return to reasonable levels of market liquidity.

It is here that the relatively idiosyncratic nature of CMBS is a benefit and not a weakness. Unlike the variously systemically important residential mortgage market, and despite the systemic significance of CRE as an asset class, CMBS is unlikely ever to grow to such a scale as to pose broad risks to the financial sector. Because investing in the asset class requires some level of fundamental analysis, its optimal scale is smaller than that of other markets (albeit much larger than its current size in Europe). At the same time, CMBS growth is a reasonable policy goal for all the reasons outlined in the DP, including providing support for SMEs (indirectly, in this case) and building financial system resilience through diversification.

Policy Options

Q5. After para 102: The view of the Bank of England and the ECB is that a 'qualifying securitisation' should be defined as a security where risk and pay-offs can be consistently and predictably understood. Do respondents agree with this definition? What characteristics of a 'qualifying securitisation' not already included in the principles in Box 3 should warrant such treatments? Do respondents have any comments on the principles in Box 3?

We agree with the analysis in paras 96 to 102, with the principles-based approach and with most of the principles included in Box 3. However, we have a number of general and more specific comments.

At a general level, and as noted in our response to Q1, it is important to remember that the benefits of a well-functioning CMBS market are needed not only at the high quality, low risk end of the market, but also for higher risk, higher return parts of the market. That is true both from the point of view of the real economy (smaller size and regional CRE loans would generally be regarded as higher risk, higher return, but the communities where the relevant CRE is located require investment just as major centres do), and from the point of view of CRE debt investors (who may want a diversified portfolio to include such exposures), and from the point of view of financial stability (do we really want to encourage banks to distribute low risk exposures while retaining higher risk exposures?). Accordingly, while we strongly support a principles-based approach for identifying simple, structurally robust and transparent securitisations, those characteristics should not be confused with risk and credit quality.

We have set out our detailed comments on the principles included in Box 3 in our response to Q18.

Q6. After para 103: Do respondents think that a liquid market for 'qualifying securitisations' available for funding would benefit from a 'qualifying certification'?

The answer to this question depends on precisely how 'qualifying securitisation' is defined. A poorly designed 'high quality' label which distorts capital allocation and flows and discriminates against whole sectors of the economy risks causing considerable damage.

On the other hand, a well-designed and correctly calibrated 'qualifying securitisation' certification could certainly help promote liquidity (as well as other benefits) in securitisation markets. Existing CMBS investors probably don't need a quality label, basing their investment decisions on their due diligence, expertise and analysis, and aided by regulatory changes already in place. However, a certification specifically and explicitly intended to encourage good market practice in the use and structuring of securitisations would build confidence among a broader pool of potential investors. Ultimately, the greatest value of a 'qualifying securitisation' label would arise from the better regulatory treatment that might result – compared to the effectively punitive and prohibitive treatment (relative to other broadly comparable investments) currently threatening some ABS

(including all of CMBS, for example under Solvency II).

Q7. After para 104: These principles may then provide a framework to aid various authorities and market participants to set their own eligibility criteria. How might such a framework be developed? What role could the appropriate authorities play in the process of certifying that a transaction is a 'qualifying securitisation'? What are the associated risks?

We would distinguish between quality controls and risk at the level of underlying loans and at the level of the securitisation structuring. In the CRE debt context, the really important issues are in our view at the level of the underlying loans.

- The poor performance of some pre-crisis CMBS relative to other ABS asset classes was principally the result of poor underwriting standards in the underlying loans. The evidence[14] suggests that CMBS performance was good compared to the wider CRE debt universe. 2011 data from the relatively data-rich UK (where banks had at that time recognised losses in, but not yet made large disposals from, their retained CRE loan books) show that default rates of 7% in securitised CRE loans compare favourably with default rates of 26% in unsecuritised CRE loans. Viewed in that way, CMBS is plainly not a product to discard, but rather one to improve, so that investors in the bonds are effectively protected from any losses in the underlying loans. That is happening, for example through more subordination in response to risks at the underlying loan level, and longer tail periods between loan maturity and bond maturity to mitigate refinancing risk.

- It is vital that the principles for designating 'qualifying securitisations' do not in effect act as a blanket exclusion for entire asset classes. That would be the effect in the CRE context of a requirement for all underlying receivables to be self-liquidating, because CRE loans (whether securitised or not, and whether benefiting from any amortisation or not) usually have a balloon payment at maturity. For CRE debt securitisations, it would be better to define eligibility characteristics for the underlying loans – for example by reference to an appropriate LTV measure, coverage levels, and tail periods between loan and bond maturity. That is the sort of approach adopted in the US for identifying "qualifying commercial real estate loans". Such an approach would recognise that the problems experienced by CMBS in recent years were a function of problems in the wider CRE debt market, which the securitisation process could do more to mitigate, but certainly did not exaggerate.

- The CRE debt market cannot realistically function based on amortisation schedules that are shorter than 25 years – and does not need to do so, as land and buildings do not suffer complete loss of liquidity and value (other than, in extreme cases, for short periods). Further, it would be a mistake to derive confidence from the fact that a CRE loan fully amortises over a 25 or 30 year period. Most buildings would require capital expenditure to maintain rental value over such a long period, and the few leases that are that long are largely limited to government type tenants. As a result, full amortisation might seem to address refinancing risk, but can only do so by greatly increasing cash flow uncertainty. A five to seven year loan may be much easier to analyse and present a lower overall risk if it is advanced at a sensible LTV[15] and/or with a modest level of scheduled amortisation.

[14] Bank of America Merrill Lynch research, cited in footnote 13 above.

[15] How LTV is calculated is important here. LTV by reference to point-in-time value at origination is a commonly cited measure, but it is not a reliable indicator of refinancing risk. An alternative is exit LTV, which takes scheduled amortisation into account. Probably the best measure for risk management purposes is LTV calculated by reference to a cycle-insensitive, long-term fundamental or investment value. The rating agencies have their own methodologies for determining LTV in such a way, and this is also the recommendation put forward in *A Vision for Real Estate Finance in the UK* (referenced in footnote 1).

- There were also problems with the way CMBS transactions were put together, with legal documentation that sometimes failed adequately to anticipate the practical challenges that in fact arose. Had the underlying loans performed, these problems may not have become apparent. The industry has been working to address them, including through initiatives such as CREFC Europe's work on CMBS 2.0[16].

See *A Vision for Real Estate Finance in the UK*[17] for considered industry recommendations about how the underlying CRE lending market might be improved. That report's focus is on promoting financial system resilience and reducing feedback loops between CRE, credit and regulatory cycles, but its recommendations would also promote healthier CRE lending markets for the benefit of market participants and equity and debt investors.

Specifically in the CRE debt / CMBS context, therefore, we believe that the industry could go a long way to address performance issues by developing eligibility criteria or quality controls for the underlying loans. At the same time, we would welcome sensible, well-designed and appropriately calibrated principles that effectively set best practice requirements for simple, structurally robust and transparent securitisation.

Subject to the points made elsewhere about the risks of distortion and harm to the real economy and financial stability from a poorly designed 'qualifying securitisation' label, the main potential risk we see is that investors might come to rely blindly on a 'qualifying securitisation' label in the way that some have done on external ratings, and fail to conduct appropriate due diligence. Ensuring that the 'qualifying securitisation' label is explicitly and specifically designed only to set standards that allow investors to assess risk (without inappropriately discriminating against specialist asset classes like CMBS), would be the best way to address that risk.

Q8. After para 107: Do respondents think that harmonisation and further conversion software could bring benefits to securitisation markets? If so, which asset classes should be targeted? How can accessibility to the existing loan level data be improved, so that it provides most value to investors?

We strongly support, and indeed promote, efforts to improve information and transparency in relation to CMBS and CRE debt markets. The use of common standards where possible is helpful both for those collecting data, and for those (in the market and at the regulator) using the data.

In the CRE debt context, information relating to CMBS and the loans underpinning CMBS issuance is generally good, especially when compared to the broader CRE debt market, which is private and opaque. CREFC Europe has created a reporting package (the European Investor Reporting Package, or **E-IRP**) with the involvement of investors, loan servicers and originators to operate as the market standard for CMBS bond, loan and property level information. The primary objective is to promote transparency, liquidity and ultimately growth in the CMBS market.

The E-IRP has been used as the starting point for their own CMBS data requirements by the Bank of England and the European Central Bank's data warehouse – both central banks recognising that it made sense to build on the existing industry standard.

There is scope to promote broader use of E-IRP across the European CMBS market (mirroring the very broad use of the equivalent investor reporting package in the United States). The E-IRP could

[16] See http://www.crefc.org/uploadedFiles/CMSA_Site_Home/Global/CMSA-Europe/Committees/European_CMBS_20_Committee/Market_Principles_for_Issuing_European_CMBS2.pdf, available at http://www.crefc.org/eucmbs20/.

[17] Referenced in footnote 1.

also be used as a starting point for the development of CRE loan information repositories for the wider, private CRE debt market, such as has been recommended in *A Vision for Real Estate Finance in the UK.*[18]
Q9. After para 110: Do respondents think that initiatives currently undertaken by authorities in this domain are sufficient or is there scope for further improvements? Would the availability of prospectuses and standardised investor reports in a single location be helpful to securitisation markets?
There is generally room for improving both access to, and comparability and consistency of, information for investors. However, it is important that decisions in this area be informed by (or even driven by) industry dialogue, to avoid the imposition of reporting requirements that fail any reasonable cost/benefit test.
Q10. After para 115: Do respondents agree that facilitating investors' access to credit data in an appropriate manner could support the emergence of securitisation markets? Would credit registers be helpful in this respect? If so, which asset classes should be targeted? In what form could access be granted to ensure that borrowers' confidentiality is preserved?
Please see our response to Q8 and Q7. We believe that a loans database which is publicly accessible (subject to minimum aggregation to preserve the confidentiality of individual lenders, borrowers and assets) would be a positive development for CRE debt markets generally. We agree with the reasoning set out in *A Vision for Real Estate Finance in the UK* (see Recommendation 1).[19] Specifically as regards CRE debt securitisation, imposing a requirement for sensible data collection and submission in relation to all CRE lending would significantly reduce one of the relative costs historically associated with CMBS, namely the reporting requirements associated with securitisation. It is important to recognise that the CRE loan (and property) level information currently available to investors in European CMBS, while not perfect, is generally far better than the information available in relation to unsecured CRE loans (and property) or in relation to CRE-backed covered bonds.
Q11. After para 115: In order to aid performance measurement and to provide investors with industry-level data, would it be helpful if certain macro-economic data were disclosed or if banks/ non-banks published certain aggregated standardised data? What are the challenges of providing potential investors with sufficient borrower and loan-level data to enable them to model credit risk, and how can these be overcome? What other elements would in your view help to improve secondary market functioning for [high-quality] securitisation?
We generally support these suggestions and refer you to earlier responses. In particular, we would like to see wider use of the E-IRP reporting framework for CMBS (and perhaps of a simplified version of E-IRP adapted for the purpose in relation to non-securitised CRE loans).
Q12. After para 116: Do respondents think that authorities should consider encouraging the industry to develop such benchmark indices? What risks might these give rise to? What indices would be most useful and which could be easily produced?
Developing benchmark indices would be more challenging in the context of the CRE debt market than in debt markets that are larger and more homogeneous. An additional challenge is the lack of

[18] That report is referenced in footnote 1 and is also discussed in the Bank of England's Discussion Paper of 29 May 2014, *Should the availability of UK credit data be improved?* (itself referred to in para 112 and footnote 10 of the present DP).

[19] Referenced in footnote 1.

credit and performance data in CRE debt markets, which (with the exception of CRE debt that has been securitised) remain opaque. We support proposals for better public data in CRE debt markets, such as the recommendation for a loans database proposed in *A Vision for Real Estate Finance in the UK* and referred to in the Bank of England's Discussion Paper on improving the availability of UK credit data (see footnotes 1 and 18).
Q13. After para 117: Do respondents agree that additional information in the form of a matrix showing implied ratings if the sovereign and ancillary facilities rating caps were to be set at higher levels would be helpful in supporting the investment process and contribute to increased transparency and liquidity?
We agree that this would be very helpful and should facilitate sensible use of securitisation in countries with lower sovereign ratings.
Q14. After para 123: How important do respondents see the impediment related to the availability of ancillary facilities? Would the benefits of facilitating SPV bank accounts that fall outside the originator's insolvency estate outweigh the costs of such an initiative? Are there other initiatives in this area that would be beneficial?
We would supplement the discussion and suggestions in the DP as follows. Any CMBS transaction seeking an AAA credit rating will be required by the rating agencies to feature a liquidity facility to cover short-term disruptions or delays in cash flows. Historically, these facilities received beneficial regulatory capital treatment, which recognised the minimal credit risk they entailed as a result of their super-senior payment priority (ahead of the AAA rated securities themselves). Changes to the regulatory capital treatment of such liquidity facilities under Basel III require liquidity facility providers to maintain substantially higher levels of capital. This has caused many potential providers to withdraw entirely from the market, and significantly higher margins are being charged by the few remaining lenders. At the same time, as the duration of CMBS securities is increasing (due at least in part to the move to longer tail periods between loan and bond maturity, discussed elsewhere in this submission), liquidity facilities are required for longer, so the increased costs associated with them matter more. The lack of affordable liquidity facilities seems likely to limit the issuance of CMBS in the future and will somewhat arbitrarily limit the pricing advantage that capital markets finance should provide. A number of recent European CMBS transactions have been issued without a rating, because of the difficulty of putting in place the liquidity facilities rating agencies require at an affordable price. That trend seems unfortunate. We do not believe that the risks associated with the provision of a properly structured liquidity facility supporting AAA securitisation bonds are such as to justify the higher capital charges imposed on them. We would encourage consideration of targeted exemptions so that the sensible use in securitisations of liquidity facilities is not compromised unnecessarily.
Broader questions
Q15. After discussion of policy options: With regard to the policy options mentioned, are there any other considerations authorities should be mindful of?
We have explained in Appendix 1 and more generally in this submission that CRE is an inherently

lumpy and heterogeneous asset class which to some extent inevitably feed through to the loans that are made against it. CRE debt cannot be approached in a similar way to most other ABS asset classes – but it is at least as important in terms of its function in the economy. Regulators also need to be mindful of the fact that the financial stability challenges connected with CRE markets are a function of the wider, overwhelmingly private and opaque, CRE lending market. We applaud and support industry efforts, and collaboration with policymakers, to address those challenges. CMBS is part of the solution, not part of the problem. While greater transparency and a degree of standardisation have a vital role to play in creating a healthier, more diverse and stable CRE debt market, there are limits to what can sensibly be achieved, set by the nature of land and commercial buildings. Insisting on granularity or full amortisation in the CRE debt context is like asking cyclists to wear parachutes. You need to understand the nature and risks of cycling before you defining the appropriate protection. Refinancing risk is a structural feature of the CRE debt market linked to the nature of commercial buildings and the businesses that own them – it cannot realistically be eliminated altogether, and any 'qualifying securitisation' label needs to acknowledge that reality. Do regulators simply want to ensure that refinancing risk remains in originating banks?
Q16. After discussion of policy options: Do respondents think there are other policy options authorities should consider to support the emergence of simple, transparent and robust securitisation markets?
From the point of view of CRE and CMBS, policymakers should encourage implementation of the recommendations in *A Vision for Real Estate Finance in the UK*[20] to improve both the structure and nature of the CRE debt market and industry and the regulatory framework that applies to it. While those recommendations are focused on the UK, there is much that could valuably be implemented internationally; and while the recommendations focus on CRE debt markets rather than securitisation, their implementation would address many of the problems that have affected CMBS. Regulators should also continue to support industry initiatives to develop, improve and disseminate best practice standards and, to the extent possible in particular contexts, standardisation of documentation and terminology (at the underlying loan level as well as in securitisation documentation).
Q17. Beyond securitisation, might there be other ways of achieving (some of) the benefits of securitisation as outlined in Section 2? What might be the associated risks of such options?
We refer you to our answer to Q16. We do not see any particular risks associated with the suggestions we make there.
Box 3
18. Do the principles set out in Box 3 seem broadly sensible given the objective of encouraging a set of securitisations that are more amenable to risk assessment? Are there any obvious unintended consequences?
We have discussed our main concerns elsewhere in this submission. Specifically by reference to the proposed principles set out in Box 3: ***Para 124 (evidence of relative performance)***: We can see a tension between this para and the points

[20] Referenced in footnote 1.

made in para 126 (with which we agree) about the aims of the proposed principles. It is important not to be distracted by performance during the crisis, and to ensure that reference points and comparisons are meaningful and relevant. Some CMBS performed poorly relative to other ABS, but chiefly that was because of underlying underwriting standards which affected balance sheet lending by banks in the same way – it was not the result of securitisation structuring. That can be seen from the fact that the performance of loans in CMBS relative to the much bigger CRE loan market was good (as noted above). It is important to remember that "modelling risk with confidence", as mentioned by para 126, need not be (and in the CRE/CMBS context, generally should not be) a statistical exercise: it may very appropriately instead involve asset-by-asset due diligence.

Para 129 (Underlying asset performance history): As noted above, verifying asset performance history needs to be approached differently in the CRE debt context – so much depends on individual buildings, leasing positions, and a range of objective and subjective factors that in most cases the important thing is access to information and the opportunity to conduct asset specific due diligence. The key is not granular data that might allow statistical analysis.

Para 131 (Expectation of payment): We think that this requirement is inappropriate and unnecessary for CMBS. Unless the underlying portfolio is very granular and more akin to an SME ABS transaction, the originators of large-loan CMBS securitisations will not necessarily have a large number of similar loans on the balance sheet, and data relating to any such business would in any event be of doubtful value for investors conducting their due diligence. The heterogeneity and 'lumpiness' of CRE means that greater transparency to the loans and the real estate underpinning the CMBS issue in question is much more valuable for investors seeking to assess risk than data relating to a wider CRE lending business. Accordingly, we do not believe that para 131 is necessary or useful for CMBS (any more than it would be for corporate bonds, for example). To the extent that this proposed principle is intended to promote better alignment of interests, as explained above, the evidence suggests that misalignment of interests has not been a problem in the CRE/CMBS context; and to the extent that it may be, risk retention should be adequate to address it.

Para 132 (Current and self-liquidating):

As explained above (see in particular our response to Q7), the CRE lending market is not a fully amortising market, for good reason – in the large majority of cases, full amortisation is neither commercially feasible nor necessary (or reliable) to address refinancing risk. Fully amortisation over a typical five year loan term would be deeply unattractive for borrowers; and banks (a vital class of lender and historically the overwhelmingly dominant one in Europe) are strongly disincentivised, for perfectly sensible reasons, for lending at longer maturities. Most strong borrowers with good quality assets would in any event resist pressure for fully amortising loans, creating adverse selection risk for securitisable CRE debt.

Imposing a self-liquidating requirement for CMBS to benefit from 'qualifying securitisation' status would in effect exclude CRE debt from securitisation markets. That would represent a missed opportunity to promote financial system (and property economy) resilience through greater diversification (of lenders and products). It would do nothing to address refinancing risk in the CRE debt market, while making it harder for that risk to be dispersed beyond the banking system. It would also make it more difficult for non-originating investors to gain relatively transparent, diversified and liquid exposure to CRE debt risk and returns; as well as limiting the amount and the choice of debt products available to property businesses wishing to invest in the built environment. It would also discourage and disempower industry efforts to address past weaknesses in the CMBS

and wider CRE debt markets.

Refinancing risk plainly does exist in CRE debt markets, and it is discussed extensively in *A Vision for Real Estate Finance in the UK*.[21] That Group's most targeted recommendation for addressing it is the proposal that regulated lenders should use a cycle-insensitive long-term value measure when calculating LTV for risk management purposes, with capital charges linked to that LTV calculation rather than to one based on point-in-time market value. This suggestion is not revolutionary: Germany's *Beleihungswert* concept and the rating agencies' own calculations of LTV when rating CMBS bonds follow a similar logic. This solution seeks to moderate the feedback loops between CRE, credit and regulatory cycles and to reduce overall risk in the financial system. A full amortisation requirement in the 'qualifying securitisation' definition, while simpler, would not have those effects.

When CRE debt is securitised, refinancing risk is mitigated – even if that mitigation was not sufficient in all pre-crisis CMBS issues. The rating agencies are already increasing the protection they require to address it, for example by lengthening the tail periods between loan maturity and bond maturity. Promoting practical and effective mechanisms for disclosing and managing refinancing risk for bond investors would support more effective mitigation of refinancing risk in CRE debt markets. Classifying CRE loans that do not fully amortise as automatically non-'qualifying' would not.

It is perfectly possible for analysts, rating agencies and investors to assess refinancing risk, given adequate information. The use of a credible and consistent through-the-cycle value in LTV calculations for risk management and capital purposes would be helpful in that regard. Land and buildings generally have a fundamental investment value that does not disappear, and a moderate level of debt at loan maturity will almost always be refinanceable before the end of a reasonable tail period to bond maturity. That can be achieved through a sensible LTV at origination, or an appropriate amount of scheduled amortisation during the life of the loan, or a combination of the two. Alternatively, there may be value in considering the the US definition for "qualifying commercial real estate loans" in the context of the risk retention rules. This sort of approach would be entirely compatible with the aims behind the proposed principles, and the principles should be amended accordingly.[22]

[21] Referenced in footnote 1.

[22] We have not been able, during the time available, to model particular combinations of LTV (with particular approaches to defining "V"), scheduled amortisation and tail periods against CRE market cycles so as to determine what appropriate levels would be, but we are confident that could and should be done to derive a more pragmatic and effective principle than para 132 in its current form.