



June 24, 2016

Mr. William Coen
 Secretary General
 Basel Committee on Banking Supervision
 Bank for International Settlements
 Centralbahnplatz 2, CH-4002 Basel
 Switzerland

Dear Mr. Coen,

The Commercial Real Estate Finance Council (CREFC) and The Commercial Real Estate Finance Council Europe (CREFCE) (collectively, “the Associations”) represent the largest bank and non-bank lenders, investors and other market participants in regional and global commercial real estate (CRE) financing.¹ The Associations appreciate this opportunity to comment on the March 2016 Consultative Document issued by the Basel Committee on Banking Supervision (BCBS; “the Committee”), named “Reducing variation in credit risk-weighted assets – constraints on the uses of internal model approaches” (“the Consultative Document” (CD)).

The Associations support the Committee’s desire to reduce variation in risk weights across the banking sector, and as it specifically relates to the commercial real estate (CRE) sector in the form of specialized lending (SLE), income producing real estate (IPRE)² and lending to financial institutions. Alignment of goals, requirements and outcomes of rules across jurisdictions is essential given the globalization of the financial sector.

At the same time, the Associations submit that the methodologies applied in the CD give rise to risks, and often do not address the root problems successfully. As such, the enclosed letter contains recommendations to help achieve a better balance between the Committee’s goal, the standardization of outcomes, and the more critical objective, maintaining risk sensitivity in the capital allocation framework.

Principal Issues

- The internal ratings based (IRB) framework for dealing with SLEs is well designed as it is: it provides for slotting as a conservative fallback solution, if a firm fails to secure regulatory approval due to data quality or methodological inadequacies. Many of the root causes of the variance in IRB outcomes are legitimate and / or cannot be addressed by abandoning the IRB approach:
 - Some of the inconsistencies are driven by differences in regulatory capabilities and implementation processes at the national level.

¹ Descriptions of the Associations are provided in Appendix 1 of this letter.

² IPRE financings refer to non-owner occupied loans that are secured by mortgages.

- If one of the core concerns for the regulators is poor data histories, then there is little support for the idea that the regulatory calibrations will prove more accurate than the industry's.
- Some of the variances reflect differences in the level of risk in the related exposures. SLEs are inherently heterogeneous and exposures that might appear comparable may not be. Each CRE asset is different, and itself changes over time, depending on the condition of the building, the lease structure and quality of its tenants and the surrounding environment. Additionally, regulators must consider the impact of the national legal system on the security and the general performance of the IPRE asset class in a given jurisdiction.
- The Associations assert that a reduction in the risk sensitivity of the capital framework will result in other challenges besides variance in outcomes, including:
 - **Reducing the quality and quantity of market data.** Better data collection (and in appropriate cases data pooling) supports better risk management by firms, and better micro- and macro-prudential regulation by authorities. Those are important objectives, which will become more difficult to achieve if the ability to use internal models for SLEs (and thus a powerful incentive to improve data) is completely removed.
 - **Discouraging low risk lending.** Neither the revised standardised approach (SA) nor slotting are suitable for low-risk IPRE lending, and both lack appropriate risk weights for it. Similarly, the proposed treatment of lending facilities drawn to financial services firms is also hampered by lack of flexibility, in that the IRB will be replaced with the SA. Risk sensitivity leads to better-informed capital allocation decisions by encouraging banks to align capital costs with greater risks. A flatter risk environment, such as the one proposed in the CD, can result in adverse selection; banks will possibly seek to maximize rewards by originating higher risk loans that may be insufficiently supported by capital.
 - **De-emphasising economic risk.** Reducing the importance of risk profiles in the capital framework creates a discontinuity between capital allocation and risk management within an institution. This aspect of the CD creates a cultural disconnect between two critical functions within a bank and it also reduces the utility of the financial investment made to create and maintain the risk systems necessary to the sound functioning of financial institutions.

Recommendations Regarding Components Relevant for Commercial Real Estate Lending

In order to maintain more of a balance between standardization and risk sensitivity, the Associations recommend that the Committee retain flexibility, and the incentives it provides, in the credit risk framework, in particular by (a) retaining (perhaps on a more consistently applied basis) the ability to use internal models for SLEs, and (b) ensuring that the number and range of risk categories under slotting and the risk weights attached to them are appropriate. The Associations focus on two aspects of this CD that affect CRE most directly:

- 1) The proposed removal of the IRB approaches for SLEs that use banks' estimates of model parameters, leaving only the SA and the IRB supervisory slotting approach (slotting), both of which apply to the IPRE category.

- 2) The proposed removal of the IRB approaches for exposures to “banks and other financial institutions” for use with lending arrangements extended to funds and other financial institutions investing in real estate, and which will consequently be subject to the SA for credit risk capital calculations.

In both instances, the Associations consider that the existing framework does not need fundamental reform: it is appropriate to allow the use of internal models where they and the data feeding them are of sufficiently high quality, and to impose the use of slotting in other cases. The Committee might make a valuable contribution to reducing variation in credit risk weighting by (i) providing guidance to national supervisors as to when it is appropriate for a model and the data on which it is based to be approved; (ii) increasing the number of slots under slotting to allow greater risk sensitivity and lower risk-weights for very low risk lending; and (iii) allow the industry to provide support for revised parameter and risk weights.

Specifically in relation to (ii) above (improving the risk sensitivity of slotting), even if the lowest available risk weight of 70% (or 50% where the remaining term is less than 2.5 years) is appropriate for exposures close to the boundary between “Strong” and “Good”, it is certainly not appropriate for the very lowest risk exposures. It is difficult to see why risk weights that bear no relation to economic risk should prevent banks from lending competitively against the best assets and covenants, with low loan-to-value (LTV) and high debt service coverage ratios. We would encourage the Committee to reconsider the number of slots is increased, allowing the banks the option of more granular and risk sensitive treatment for their loans held on balance sheet. This is especially important at the lower range of the scale in order to encourage lower risk lending.³ We would encourage the Committee to consider increasing the number of slots, in particular to add lower risk weights for the very safest exposures.

Inconsistencies between the proposed revised SA and slotting

Additional concerns arise when one compares slotting (as it currently stands) with the more risk sensitive framework proposed for income-producing commercial real estate exposures under the revised SA. It is unfortunate that the Committee did not set out all these proposals side by side so that they could be assessed holistically.

Slotting is likely to be used by more sophisticated banks generally using an IRB approach, many of which may currently have an approved model for IPRE exposures. It offers four risk-weights for non-defaulted CRE exposures, ranging from 70% (50% for short-term exposures) to 250%, with a relatively complex range of factors having to be considering in assigning risk-weights.

The revised SA is likely to be used by less sophisticated banks that never moved to the more risk-sensitive approach contemplated by Basel II. It offers three risk-weights for non-defaulted CRE exposures (and a separate, higher, risk-insensitive one for land acquisition, development and construction exposures). These range from 80% to 130%, and depend on a simple assessment of LTV.

It is clear why a simpler approach to assigning risk-weights is proposed under the revised SA than under slotting; but it is not clear why the two regimes have almost the same number of risk categories (but not quite). It is also far from clear why the risk weights are calibrated as they are (similar but different at the low risk end of the

³ CREFC encourages the Committee to note that the industry has reported dislocations in land acquisition, development and construction lending due to the implementation of a the High Volatility Commercial Real Estate treatment in the United States, partly due to the precipitous increase in capital costs (100% to 150%) and partly due to other factors, such as imprecise definitions.

spectrum, very different at the high risk end of the spectrum). Is the Committee seeking to place standardized banks at a competitive advantage in relation to riskier SLEs?

The broader context

More generally, maintaining a focus on better data (and where reasonably practicable data pooling) should be an important policy goal in relation to SLEs and particularly IPRE exposures. That would support both better risk management by individual banks, and more informed and effective micro and macro prudential supervision by regulators. Evidence could be gathered to justify maintaining, or modifying, existing risk weights, parameters and calibrations. Initiatives such as ongoing work in the United Kingdom on the creation of a CRE loan database should therefore be encouraged. Unfortunately, the Committee's current proposals risk sending a powerful message that such initiatives may not be worth the effort, by breaking the link between evidence-based assessment of economic risk and risk weighting for regulatory capital purposes.

Conclusion

In conclusion, the Associations thank the Committee for the opportunity to recommend refinements to the CD. In short, we consider that significant modifications to the proposals are required if they are to deliver genuine improvements in terms of micro or macro prudential regulation and risk management – the existing IRB framework for SLEs is not in need of the kind of overhaul that is proposed.

Whether or not the Committee is persuaded by that argument, we urge it to review the number of risk categories and the associated risk weights under the slotting framework for SLEs. Slotting was not conceived as a dominant capital framework for SLEs. If it is to become that, a thorough, consultative review is required, using evidence from countries like the United States and the United Kingdom that have expanded its use in recent years.

At the CRE market level, dramatically reducing risk sensitivity would seem likely to reduce the availability, and increase the cost, of credit, impacting productive investment without necessarily reducing risk in the banking system. The Committee should strive to avoid such an outcome.

We look forward to answering any questions that the Committee may have. Please contact Peter Cosmetatos at pcosmetatos@crefcurope.org or Christina Zausner at czausner@crefc.org with any questions.

Sincerely,



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The CRE Finance Council (CREFC) is the collective voice of the more than \$3.5 trillion commercial real estate finance market, and our members include all of the significant portfolio, multifamily, and commercial mortgage-backed securities lenders and issuers; loan and bond investors such as insurance companies, pension funds and money managers; servicers; rating agencies; accounting firms; law firms; and other service providers. CREFC's membership consists of more than 300 companies and 8,000 individuals. Our industry plays a critical role in the financing of office buildings, industrial complexes, multifamily housing, retail facilities, hotels, and other types of commercial real estate that help form the backbone of the American economy. In addition to its sector specific member forums, committees and working groups, CREFC acts as a legislative and regulatory advocate for the industry, plays a vital role in setting market standards and provides education for market participants in this key sector of the global economy. For more information visit www.crefc.org



The Commercial Real Estate Finance Council (CREFC) Europe is a trade association promoting a diversified, sustainable and successful commercial real estate debt market in Europe. Our core membership includes commercial and investment banks, as well as other lenders and intermediaries who help connect capital seeking the risk and returns of commercial real estate debt with real estate businesses seeking finance. We seek constructive and effective dialogue not only with our member firms, but also with non-originating investors, borrowers and regulatory authorities, with a view to promoting commercial real estate debt markets that support the real economy without compromising financial stability.