13 May 2015

Response of the Commercial Real Estate Finance Council (CREFC) Europe to the European Commission's Consultation Document: An EU framework for simple, transparent and standardised securitisation (published on 18 February 2015)

CREFC Europe is grateful for the opportunity to comment on this consultation document (the **CD**).

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.

We believe that an effective framework for simple and transparent CRE debt securitisation, with the degree of standardisation that can reasonably be achieved in so heterogeneous an asset class, has a vital role to play in promoting a CRE debt market that serves the needs of both the real economy and investors, while also supporting financial stability.

This response presents the perspective of the CRE and CRE debt industry only, focusing on the implications of these proposals on the securitised CRE debt market.

Responses to questions

Q1.A. Do the identification criteria need further refinements to reflect developments taking place at EU and international levels? If so, what adjustments need to be made?

A holistic (cross-product and sector) review of the regulatory framework for securitisations and other investment products should be conducted as part of any attempt to improve the identification criteria to take into account developments at both EU and international levels. It is all too apparent that different well-intentioned regulatory initiatives developed piecemeal and in separate silos are giving rise to odd relative outcomes which could drive undesirable market behaviours and undermine policy goals.

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 (both in Europe and internationally) 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 "modular approach" adopted by the identification criteria as a positive step towards the second objective (albeit subject to some important comments, discussed below). However, we are troubled by the way relevant aspects of Solvency II have evolved (discussed further below), which provides a clear example of why a holistic (cross-product and sector) review of the regulatory framework for securitisations and other investment products should be conducted.

It is also important that, in highly globalised capital markets, the EU adopts an approach that is consistent with global regulatory initiatives such as the BCBS-IOSCO work on simple, transparent and comparable securitisation, and compatible with evolving regulatory approaches in the United States. Unnecessary inconsistencies risk creating arbitrage and distortions, disadvantaging access to finance for European businesses and access to investment markets for European investors.

Q1.B. What criteria should apply for all qualifying securitisations ('foundation criteria')?

We broadly agree with the identification criteria insofar as such measures encourage good structuring practice so that unnecessary complexity is avoided and due diligence by investors and analysts is made easier. Indeed, a regulatory framework along the lines proposed, specifically in relation to securitised CRE debt, could play a vital role in enhancing financial stability, improving transparency and liquidity for investors, and strengthening the flow of responsible credit to a vital, enabling sector of the real economy. We strongly support simplicity and transparency as cornerstones of any such framework. However, there are limits to how far standardisation is either possible or desirable in the context of a heterogeneous asset class such as CMBS vis-à-vis other asset classes.

CRE is an inherently lumpy and heterogeneous asset class which to some extent inevitably feeds through to the loans that are made against it and therefore the CMBS transactions featuring such loans. 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 need to be mindful of the fact that the financial stability challenges connected with CRE markets are a function not of securitisation, but of the wider, overwhelmingly private and opaque, CRE lending market. It is important to support industry efforts, including 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 CMBS market, there are limits to what can sensibly be achieved, set by the nature of land and commercial buildings securing the underlying loans. With a view to standardising and improving securitisation, some policy makers have suggested that full amortisation of securitised loans and high granularity/low concentration at the borrower level should be prerequisites. In the context of CRE debt, we would liken such measures to asking cyclists to wear parachutes. You have to understand the nature and risks of cycling before you can design appropriate safety measures. Some degree of refinancing risk is a structural feature of the CRE debt market, linked to the nature of commercial buildings and the businesses that own them. As regards granularity, CRE debt credit risk depends on tenants and lease structure, not the number of (typically non-recourse) borrowers; and fewer borrowers are easier for investors to due diligence, and can also offer cross-collateralisation benefits. Any 'qualifying securitisation' label needs to acknowledge and work with these realities.

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).

Q2.A. To what extent should criteria identifying simple, transparent, and standardised short-term securitisation instruments be developed? What criteria would be relevant?

As a medium-term (5-10 years) asset class, CRE debt is not generally a natural fit for short-term securitisation markets. Accordingly, we have no comments on this question.

Q2.B. Are there any additional considerations that should be taken into account for short-term securitisations?

As a medium-term (5-10 years) asset class, CRE debt is not generally a natural fit for short-term securitisation markets. Accordingly, we have no comments on this question.

Q3.A. Are there elements of the current rules on risk retention that should be adjusted for qualifying instruments?

It is understood that the position for risk retention imposed by the Capital Requirements Regulation (CRR) is etched in stone and that there is little appetite for this to be changed. That said the current definition of "securitisation" in the CRR creates a number of questions on what actually constitutes a securitisation, for example in the context of agency CMBS transactions. (Agency CMBS consist of bond financing being provided directly to a real estate-rich business, rather than involving the refinancing in the capital markets of a loan or loans advanced by a bank. The corporate borrower group is the originator of the capital markets transaction and is exposed to market risk until it is executed. Agency securitisations are, in effect, secured corporate bond issues which rely on cash flows from the assets of the business in question. They are not a bank financing tool.) Confidence in the CMBS market (for originators and investors alike) would be improved by some clarification.

We can see the case for reducing retention requirements for qualifying instruments. Doing so would be in line with the US approach of eliminating retention and "retention sunset" clauses with respect to qualifying assets. Implementing similar measures in the EU would promote greater harmonisation at an international level.

Q3.B. For qualifying securitisation instruments, should responsibility for verifying risk retention requirements remain with investors (i.e. taking an "indirect approach")? Should the onus be only on originators? If so, how can it be ensured that investors continue to exercise property due diligence?

The existing indirect approach has generally proved workable and we support it, subject to the following concern in relation to ongoing, rather than day one, compliance. While it is appropriate for investors to be responsible for ensuring that a transaction is compliant at the point when they invest, it is perhaps less appropriate for them to be penalised in situations where the retention requirement was met at the point of purchase but subsequently not complied with during the holding period of the security. This extends to the case of insolvency of the entity which held the retention originally. In such cases investors should not bear a penalty for non-compliance. Similarly investors should not be forced to increase regulatory capital or sell at loss securities which have become non-compliant through no fault of the investor and subsequent to the initial purchase of a compliant security.

Q4.A. How can proper implementation and enforcement of EU criteria for qualifying instruments be ensured?

The greatest benefit of a qualifying securitisation framework lies in its capacity for driving best practice, helping to reduce the prevalence of unnecessarily complex or opaque instruments and, as a result, enhancing the stability and credibility of the securitisation market as a whole. The longer term objective of a qualifying securitisation label should be that most, if not all, securitisations should meet its criteria. This vision would seem to recommend a certain amount of flexibility in the way the framework is designed, implemented and enforced.

More specifically, we see two broad options for implementation. Either a third party (the regulator or some kind of independent agency or auditor) assesses and certifies compliance, or there is self assessment and certification (by issuers or by investors). In either case, there should be clear criteria that can be objectively interpreted to minimise uncertainty; practical and effective mechanisms for resolving uncertainty or disputes should be put in place; and the consequences of non-compliance should be considered, for both issuers and investors. If a third party were to assume responsibility, it would be important to ensure that conflicts of interest can be avoided and that it has the capacity (and asset class-specific expertise) to perform the role, given the tight timeframes in which many securitisations (including of CRE debt) are implemented.

Q4.B. How could the procedures be defined in terms of scope and process?

This response is focused on the substantive effect of the criteria rather than on the technical mechanisms for implementing it. It is vital that the principles for designating 'qualifying securitisations' do not in effect act as a blanket exclusion for entire asset classes. Any certification on what constitutes a qualifying securitisation should be transparent and unequivocally clear on satisfaction of all relevant qualifying criteria. We note that, given the heterogenous nature of CMBS and indeed, some of the structural nuances associated with other asset classes, the qualifying securitisation certification should be tailored for individual asset classes. A "one size fits all" approach would risk excluding entire securitisation asset classes (and by extension entire sectors of the economy) from the benefits of the proposed qualifying securitisation framework.

Also, while we strongly support the designation of a "qualifying securitisation" to identify simple, structurally robust and transparent securitisations, those characteristics should not be confused with risk and credit quality. At a general level, 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 and from the point of view of CRE debt investors. In terms 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. From the investor point of view, it would be strange to remove the regulatory incentive for simplicity and transparency from higher risk/return securitisation investments to which capital might quite appropriately be allocated.

Finally, from the financial stability perspective, it is CRE debt generally, not the modest extent to which CRE debt is securitised, that poses potential risks. Indeed, securitised CRE debt, whatever its inherent characteristics and pre-crisis failings, is still the best mechanism for transferring CRE risk within the financial system and the only meaningful window of transparency into the wider CRE debt market. If securitised CRE debt is denied the regulatory incentive for simplicity and transparency, or if that incentive is restricted to low risk CRE debt, the effect would be to limit both the extent to which (higher risk) CRE debt can be transferred by those originating it to other investors, and the extent to which regulators, analysts and investors can see and analyse what is happening in CRE debt markets.

Q4.C. To what extent should risk features be part of this compliance monitoring?

We would distinguish between quality and risk controls 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. Recent research has shown that, of over 1,000 CRE loans across 184 European CMBS transactions issued between 2000 and 2013, all of the loans experiencing losses were originated at the top of the CRE market, between 2005 and 2007 (See *European Structured Finance – CMBS: Historical drivers of CRE loan performance*, a research paper published by Bank of America

Merrill Lynch on 19 March 2015). Lack of data makes a comparable analysis of unsecuritised CRE debt impossible, but we believe a similar picture would emerge – the greatest risk factor in CRE debt (whether securitised or not) is cycle or vintage risk. The most robust data we have seen comparing securitised and unsecuritised CRE loan performance is based on UK data from 2011 (where banks had recognised losses in, but not yet made large disposals from, their CRE loan books). The data indicate default rates of 7% in securitised CRE loans compared to 26% in unsecuritised CRE loans. See Bank of America Merrill Lynch's *European CMBS 2012 Outlook and 2011 Review*, published on 12 January 2012. It was indifferent CRE lending at the top of the cycle that caused losses to CMBS investors, not the securitisation of the relevant loans. It follows that:

- the risk associated with CRE lending in exuberant markets is present in the financial system – whether or not it is securitised determines how that risk is distributed (and how visible it is to regulators, analysts and investors), not its quantum; and

- the best way to help non-originating investors in CRE debt (whether through securitisation markets or otherwise) would be to promote and develop industry initiatives aimed at improving market information, cycle-insensitive metrics and counter-cyclical regulation. One important initiative along these lines is *A Vision for Real Estate Finance in the UK*, a May 2014 report produced by the independent Real Estate Finance Group in the UK, which is available at http://www.ipf.org.uk/industry-involvement/a-vision-for-real-estate-finance-in-the-uk.html and uploaded with this response. Among its recommendations are the creation of a comprehensive CRE loan database and the development and use of a long-term value concept (comparable to mortgage lending value concepts used in certain European countries). While the report has a UK focus, most of its recommendations have international application.

A qualifying securitisation label can play a valuable role in helping identify and mitigate risks associated with the structuring of securitisations, including through better disclosure and transparency relating to the underlying loans. However, we do not believe a qualifying securitisation framework should seek to regulate, or operate by reference to, risk features of the underlying loans themselves.

Rather than excluding CMBS from any qualifying securitisation label, regulators should be working hard to ensure the label is one whose criteria better-structured CMBS can satisfy. That would give CMBS investors the benefit of improved standards of simplicity and transparency, and give encouragement to industry efforts to address past weaknesses in CMBS structuring and to improve disclosure standards and loan documentation. See for example the Market Principles for Issuing European CMBS 2.0, published by CREFC Europe in November 2012 (available at http://www.crefc.org/uploadedFiles/CMSA_Site_Home/Global/CMSA-Europe/Committees/European_CMBS_20_Committee/Market_Principles_for_Issuing_European_CMBS2.pdf and uploaded with this response). Other initiatives focus on consistent and comprehensive data reporting (see CREFC Europe's European Investor Reporting Package initiative at http://www.crefc.org/e-irp/) and the development of more standardized documentation for CRE lending (see the Loan Market Association's suite of Real Estate Finance documentation at http://www.lma.eu.com/documents.aspx?c=100).

The market is already exploring asset class-appropriate ways of enhancing the resilience of CMBS to CRE loan losses, for example through lower leverage at the level of the underlying loans, and longer tail periods between loan maturity and bond maturity to mitigate refinancing risk. The criteria for qualifying securitisations should accommodate such asset class-specific approaches. One way of doing that might involve defining eligibility characteristics for the underlying loans – for example by reference to an appropriate LTV measure and income coverage levels – and recognising the importance of tail periods between loan and bond maturity for mitigating bond refinancing risk. Such an approach would be in line with the US approach for identifying "qualifying commercial real estate loans" and 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 did not exaggerate.

Q5.A. What impact would further standardisation in the structuring process have on the development of EU securitisation markets?

We strongly support the policy initiative to revive healthy, well-functioning and prudentially sound securitisation markets: generally, and for securitised CRE debt (CMBS) in particular. We agree that doing so – for securitisation generally and for CMBS in particular – would benefit both the economy and financial stability. It is a good idea to encourage positive market evolution by privileging securitisations (generally and within CMBS in particular) that meet appropriate criteria reflecting simplicity, standardisation and transparency.

Given the importance of CRE in the real economy and the historic sensitivity of financial stability to CRE debt, it is really important the Commission's policy objectives are pursued specifically for CMBS, and not in a way that risks entirely excluding CMBS from any 'qualifying' securitisation concept. That can only be done if the identification criteria are capable of being satisfied by CMBS, having regard to the structure and logic of the wider CRE debt market.

More generally, we would remind the European Commission that securitisation represents only a small part of the European CRE debt market (no more than EUR70 billion out of a total of around EUR1 trillion). Most of the risks that CRE debt can pose to banks, financial stability, investors and taxpayers are a function of that wider market, and need to be addressed at that level. We refer you to *A Vision for Real Estate Finance in the UK* (referenced above and uploaded with this response) for a useful analysis of the CRE debt market and how it might be made safer (many of its recommendations are relevant beyond the UK).

In terms of standardising the securitisation structuring process, the important point to remember is that a "one size fits all" approach will not cover both securitisation of homogeneous retail loan products like residential mortgages, credit card receivables and auto loans and heterogeneous commercial loan products like CRE debt. In the CRE debt context the room for standardisation is inevitably modest. We would also highlight the different legal systems affecting the CRE debt market (e.g. insolvency and property law) which would inevitably restrict the scope for standardisation.

Q5.B. Would a harmonised and/or optional EU-wide initiative provide more legal clarity and comparability for investors? What would be the benefits of such an initiative for originators?

As indicated in our response to Q5.A, we would counsel against the imposition of a harmonised requirement across very different underlying asset classes. We would support encouragement for standardisation and comparability to the extent reasonably achievable within particular asset classes.

Q5.C If pursued, what aspects should be covered by this initiative (e.g. the legal form of securitisation vehicles; the modalities to transfer assets; the rights and subordination rules for noteholders)?

Please see our response to Q4.C. 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 at the level of the underlying loans. However, aspects of the way CMBS transactions were structured as the last cycle approached its peak proved problematic, and did not adequately anticipate the practical challenges that 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 (referenced in our response to Q4.C).

We also refer you to *A Vision for Real Estate Finance in the UK* (referenced above and uploaded with this response) 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 in the UK context. However, its recommendations would also promote healthier European 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.

Q5.D. If created, should this structure act as a necessary condition within the eligibility criteria for qualifying securitisations?

A single structure should only be a necessary condition within the eligibility criteria for qualifying securitisations if it is capable of applying across all relevant asset classes while also being sensitive to the particular characteristics of each asset class (so that it avoids creating inappropriate cliff-edges between asset classes). At this stage, we are not convinced that this can be achieved. An alternative approach might be to design a structure which accommodates specified exceptions to cater for the particular characteristics of different asset classes in appropriate cases.

We are particularly concerned about this issue because our impression of the regime developed by EIOPA and the criteria proposed by the EBA would inappropriately discriminate against entire asset classes. The consequences of such an approach are likely to including distorting investment capital flows, unintended impacts on the distribution of risk across the financial system and more limited or more expensive credit flows to entire sectors of the real economy.

Q6.A. For qualifying securitisations, what is the right balance between investors receiving the optimal amount and quality of information (in terms of comparability, reliability, and timeliness), and streamlining disclosure obligations for issuers/originators?

We strongly support, and indeed promote, efforts to improve information and transparency in CRE debt markets. The use of consistent and comparable terminology and standards is helpful both for those collecting data, and for those (in the market and at the regulator) using the data. However, it is very unlikely that a single prescriptive approach to information disclosure can make sense across different asset classes.

In the CRE debt context, information is actually reasonably good for loans that have been securitised. Compared to the CMBS market, the wider CRE debt market is private and opaque. CREFC Europe has created a reporting package (the European Investor Reporting Package, or E-IRP, referenced above) with the involvement of investors, loan servicers and originators. The E-IRP is 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, and the market appears to be responding.

According to research published by Bank of America Merrill Lynch on 16 February 2015, each of seven post-crisis conduit European CMBS transactions provides for quarterly reporting based on E-IRP.

The E-IRP has also 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 for regulators 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 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* (the May 2014 industry report referenced above and uploaded with this response).

Q6.B. What areas would benefit from further standardisation and transparency, and how can the existing disclosure obligations be improved?

There is generally room for improving both access to, and comparability and consistency of, information for investors. However, decisions in this area should be informed (or even driven) by industry expertise and dialogue, to avoid the imposition of reporting requirements that fail any reasonable cost/benefit test.

Q6.C. To what extent should disclosure requirements be adjusted – especially for loan-level data [for example, securitisation encompassing revolving underlying assets (e.g. credit card receivables) compared to static pools (e.g. residential mortgages)] – to reflect differences and specificities across asset classes, while still preserving adequate transparency for investors to be able to make their own credit assessments?

It is vital that disclosure requirements are tailored to the characteristics of different asset classes, taking as their starting point work already done by the industry – regulators should not reinvent the wheel. As mentioned above, it is the much larger unsecuritised CRE debt market that presents serious informational challenges (for investors and regulators); the CMBS market has already developed an appropriate data capture and reporting framework whose ever wider use should be given regulatory encouragement.

Q7.A. What alternatives to credit ratings could be used, in order to mitigate the impact of the country ceilings employed in rating methodologies and to allow investors to make their own assessments of creditworthiness?

It is noted that the regulators have placed an emphasis on reducing reliance on external ratings. Although we have no objection to this approach, it will only work if there is sufficient disclosure of information for investors to be able to conduct their own analysis.

Specifically as regards country ceilings, it is difficult to see how one can reconcile the impact that a potential insolvency of the sovereign might have on securitisation issuance from that country, on the one hand, with the desire to promote securitisation issuance that is not prejudiced by sovereign ratings, on the other. To the extent that external ratings remain importance, one might ask rating agencies to provide ratings on a basis that ignores country ceilings alongside their main ratings, and perhaps to flex regulatory capital rules accordingly (see discussion at Q7.B below). It is also possible that, in a world in which less weight is placed on external ratings, investors might reach different conclusions about the implications of sovereign risk for investing in securitisation exposures.

Q7.B. Would the publication by credit rating agencies of uncapped ratings (for securitisation instruments subject to sovereign ceilings) improve clarity for investors?

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.

Q8.A. For qualifying securitisations, is there a need to further develop market infrastructure?

In many respects, we see market infrastructure for CMBS as a matter for the industry to address, and the market has indeed been evolving since the crisis and through initiatives like CMBS 2.0 (referenced above). Secondary market liquidity falls into this category.

One area that is more difficult for the market to address relates to the costs arising from higher relative operational requirements – between CMBS and other, unsecuritised, forms of investable CRE debt, and between securitisation and other kinds of bonds. This includes information and 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.

Q8.B. What should be done to support ancillary services? Should the swaps collateralisation requirements be adjusted for securitisation vehicles issuing qualifying securitisation instruments?

In commercial terms, we would specifically highlight the challenges posed by rating agency eligibility requirements in relation to essential elements of a CMBS transaction such as liquidity facility and hedging counterparties. We would also point out that stigma among some investors is balanced by investor appetite for yield, which CRE debt-backed securities can provide in part thanks to their illiquidity premium.

The availability of liquidity facilities is a prime example of how regulatory measures have hampered the provision of such an essential ancillary service. 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 – reflecting higher capital requirements, not economic risk – are being charged by the few remaining lenders. Ironically, the problem is made worse by the fact that the duration of CMBS transactions is increasing (due at least in part to the move to longer tail periods between loan and bond maturity intended to mitigate refinancing risk). As a result, liquidity facilities are required for longer, and the impact of increased costs is greater.

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.

This trend is unfortunate, and reflects a problem that should be tackled generally, not solely in relation to qualifying securitisations. 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 of liquidity facilities in securitisations (whether qualifying or not) is not compromised unnecessarily.

We would emphasise that it is neither feasible nor necessary for securitisation SPVs to provide collateral to swap providers in the form of cash or securities. Collateral is effectively provided in the form of security over the underlying assets (whether the securitisation is qualifying or not) and this should be sufficient, particularly where a swap provider holds a senior position in the applicable priorities of payments.

Q8.C. What else could be done to support the functioning of the secondary market?

The most important regulatory objective should be to encourage growth in the scale of simple and transparent securitised debt markets, including in particular in relation to CRE debt. Currently, less than 10% of the European CRE debt market is securitised. That position is unlikely to improve if the criteria for qualifying securitisation are designed in such a way as to exclude CMBS (following the unfortunate precedent already created by Solvency II).

CMBS provides a relatively flexible and liquid way for investors to gain exposure to CRE debt risk and returns in the secondary market. There are various ways of linking CRE borrowers to non-originating sources of CRE debt besides CMBS, including the syndication market, structured products, covered bonds (where covered bond markets exist) and through debt funds. Of those, only covered bonds (where available) 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.

It is not enough to assess the performance of CMBS relative to other ABS asset classes (which mostly did better than CMBS during the crisis); yet that is all EIOPA and the EBA have done. In functional and economic terms, CMBS has to be seen as a critically underused mechanism for distributing risk, building resilience-enhancing diversity and improving transparency in the much larger, systemically important but poorly understood CRE debt market. As mentioned above, available data suggest that securitised CRE debt performed significantly better during the crisis than CRE debt originated to be held on European bank balance sheets

CMBS is part of the solution to a more sustainable and resilient CRE debt market (including greater secondary market liquidity), not part of the problem. Regulatory objectives would be best served by designing qualifying securitisation criteria that positively welcome simple, transparent CMBS.

Q9. With regard to the capital requirements for banks and investment firms, do you think that the existing provisions in the Capital Requirements Regulation adequately reflect the risks attached to securitisation instruments?

In very broad terms, we would like to see the European CMBS investment market dominated by insurers, pension funds and other long-term investors, rather than by banks (as it is in the United States). One of the weaknesses of pre-crisis European CMBS markets was the extent to which exposures remained within the banking system even after they had been securitised. For this reason, we are more concerned about the capital requirements imposed on European insurers by Solvency II than about those affecting banks and investment firms.

Having said that, higher capital requirements for banks and investment firms affect the wider securitisation investment market because of their role in providing liquidity to that market. If the capital rules strongly discourage banks and investment firms from holding securitisation exposures (such as CMBS), that can significantly reduce the attractiveness to other investors of holding those exposures – particularly given the cumulative impact of other regulatory measures (such as Solvency II for European insurers).

Subjecting securitisation exposures held by banks and investment firms to risk-based capital requirements that are much higher than those that apply under the existing securitisation framework and several times those that apply to other types of financial assets further discourages banks and investment firms from investing in, originating or sponsoring securitisation transactions. That runs counter to the stated policy objectives, and is specifically a problem in the context of CRE debt markets which need more diverse credit flow for businesses, risk transfer from the banking system and greater transparency and liquidity for non-originating investors.

Regulatory capital rules for securitisation exposures need to make sense on a relative basis, having regard to the treatment of (a) the underlying exposures and (b) comparable instruments (such as covered bonds, syndicated whole loan portfolios, etc.). Accordingly, we note that:

- The CRR preferential capital treatment of covered bonds is in material deviation from the international BIS guidelines, where such treatment does not exist.

- The double counting of credit support applied in establishing preferential capital treatment of covered bonds under the CRR relative to a similarly rated bank brings about inequitable consequences. AAA rated covered bonds are commonly issued by, and represent senior unsecured obligations of, a A (not AAA) rated bank; there is no justification for halving the capital charge for a AAA rated covered bond relative to a AAA rated bank.

- The reference to high capital charges for junior tranches should also be extended to the automatic deduction from capital of equity securitisation tranches even though they represent mainly or fully expected loss rather than unexpected loss.

- The risks of qualifying securitisations can be assessed with higher certainty than non-qualifying securitisations.

As mentioned elsewhere in our responses, it is important that any regulation such as the CRR must be sensitive to different asset classes in ways that the proposed criteria fail to be in important respects for CMBS. Regulation should minimise the presence and impact of cliff-edges between financing instruments and asset classes, to avoid distorting capital flows away from more visible and better supervised parts of the financial system, or away from entire parts of the real economy that rely on them. It is all too apparent that different well-intentioned regulatory initiatives (such as the CRR) are being developed piecemeal and in separate silos, giving rise to odd relative outcomes that will drive undesirable market behaviours and undermine policy goals.

Q10. If changes to EU bank capital requirements were made, do you think that the recent BCBS recommendations on the review of the securitisation framework constitute a good baseline? What would be the potential impacts on EU securitisation markets?

The BCBS revised securitisation framework does not differentiate between different types of securitisations. The revisions could be harmful for the EU securitisation markets due to substantially increased risk weights for mezzanine bonds.

Granularity

One specific weakness in the BCBS framework is that it penalises low granularity securitisations by reference to the number of underlying borrowers. While that may make sense for retail products, it does not make sense for securitised CRE debt for a number of reasons:

- CRE debt is typically non-recourse, so credit exposure is principally to the tenants whose rental payments support the borrower's debt service. The borrower is important by reference to its asset management skill, not in credit terms as such. In the CRE context, therefore, it would make more sense to assess concentration risk at the tenant level than at the borrower level.

- Having said that, we have not seen evidence regarding the impact of concentrated tenant risk on CRE debt performance. We can envisage cases where it may present genuine risks (for example, where the debt depends on the survival and health of a single operating business whose specialised CRE assets may not be readily marketable to alternative tenants). We can also envisage cases where it may be a strength (for example, where the single tenant is a government or quasi-government entity).

- CMBS due diligence invariably focuses on the actual borrower, assets and tenants, rather than being conducted through statistical analysis. As a result, investors will generally prefer to due diligence a small number of borrowers and underlying CRE assets.

- Finally, a number of CRE investment assets owned by the same borrower will generally present a better credit than the same assets under separate ownership, because common ownership is likely to unlock cross-collateralisation benefits. It clearly doesn't make sense for capital rules to reward securitisation of separately owned assets (with no cross-collateralisation) and penalise securitisation of assets under common ownership (with cross-collateralisation).

The BCBS securitisation framework more generally

Currently banks operate under the standard approach (**SA**) or internal ratings-based approach (**IRBA**) for securitisations, both based on ratings. We assume that EU regulation will continue to allow the use of ratings. As such, EU banks would under the revised framework either use the SEC-IRBA approach or the SEC-ERBA (external ratings-based) approach, according to the BCBS hierarchy. Only if regulators did not allow the use of external ratings would banks use the SEC-SA approach. Whether many banks will be able to use the SEC-IRBA approach is doubtful, as it necessitates a regulatory approved IRB model for 95% of the underlying portfolio. It is not easy to get IRB approval in the relatively data-thin context of CRE lending, and doing so is likely to be even more difficult for IRB models covering cross-border CRE lending (even though that would contribute towards the regulatory goal of facilitating cross-border investment, including through securitisation, to reduce fragmentation in EU markets).

Therefore, risk weights are likely to increase by several multiples, especially for junior tranches that are often rated AA or A. In the table below we have assumed a duration of five years for all classes and a 5% thickness for non-senior classes. For SEC-IRBA we assume a risk weight of 70% for the underlying assets. We further assume a retail portfolio. For SEC-SA we assume a risk weight of 100% for the underlying assets.

Rating	Current risk weight (IRB incl 1.06 scaling)	BCBS risk weight SEC-ERBA	*Multiple to current*	BCBS risk weight SEC-IRBA	*Multiple to current*	BCBS risk weight SEC-SA	*Multiple to current*
AAA	7%	20%	*2.9x*	15%	*2.0x*	15%	*2.0x*
AA	16%	115%	*7.6x*	20%	*1.3x*	64%	*4.0x*

A	21%	170%	*8.6x*	42%	*2.0x*	113%	*5.3x*
BBB	80%	295%	*3.9x*	88%	*1.1x*	201%	*2.5x*
BB	451%	720%	*1.7x*	192%	*0.4x*	357%	*0.8x*
B	1250%	995%	*0.8x*	380%	*0.3x*	1179%	*0.9x*

Under the revised framework:

- Most EU banks will likely use SEC-ERBA
- Risk weight and hence capital requirements will triple for senior bonds rated AAA.
- Risk weights and hence capital requirement may rise up to eightfold for highly (AA or A) rated mezzanine bonds
- EU banks (if allowed to use external ratings) will be disadvantaged compared with banks that are not allowed to use ratings and therefore have to use SEC-SA, as SEC-SA is (perhaps surprisingly) less conservative than SEC-ERBA.

For asset classes like RMBS/CMBS the tripling of the risk weight for AAA rated senior bonds seems punitive by comparison with the substantially lower risk weights for covered bonds, for example (which can be low single-digit). Given the lack of a level-playing field that will result, issuing senior ABS will be comparably expensive for originators (as bank investors will require a higher yield given the higher risk weights). Originators may, under the influence of capital costs, continue to prefer covered bonds over RMBS/CMBS as a funding tool, for example. For countries and asset classes without effective access to a covered bond market (as well as for any regulators wishing to see some exposures transferred out of the banking system), this situation presents real problems.

If the revised BCBS securitisation framework were implemented as planned, we would expect bank demand for (often AA or A rated) non-senior securitisation bonds to decline, and with it secondary market liquidity (assuming the revised framework will be the basis for revised trading book treatment for securitisations, as is likely). While that may, at first sight, seem a positive development, it should be remembered that securitisation only works if there is a functioning market for junior tranches. It has been reported that that market is already heavily reliant on North American investors. If regulators would like to see European securitisation markets recover, they need to acknowledge that investing in junior tranches can be a reasonable decision, and allow investors to make it without unjustifiably penal capital consequences.

To conclude, from the CRE perspective, we are concerned that the revised securitisation framework results in excessive risk weights for both senior and junior CMBS bonds, as compared to other financial instruments. For senior CMBS exposures, the revised framework risk weights are too high compared with other bank funding instruments, particularly covered bonds. Overall, higher charges for most rated tranches will force bank investors' yield requirements up, increasing the cost of securitising CRE debt for issuers to an extent that the underlying CRE loan market may be unable to bear. Viewed in isolation, pricing bank investors out of CMBS might not be a problem – but taken together with the impact of capital charges under Solvency II, it is very difficult to see how a sustainable CRE debt securitisation can emerge.

Q11. How should rules on capital requirements for securitisation exposures differentiate between qualifying securitisations and other securitisation instruments?

If the qualifying criteria are sensitively calibrated to accommodate the characteristics of different asset classes including securitised CRE debt, we agree that qualifying securitisations should enjoy privileged capital treatment. One way of differentiating might be to apply an additional capital charge to securitisations that fail to meet the criteria. Provided the criteria do not discriminate between different asset classes, the cliff-edge that would exist between securitisations that meet the criteria and those which do not might reasonably be justified.

In this context, it is worth highlighting the dangerously distortive impact that poorly designed regulation can have. The Solvency II regime imposes 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 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 owns the real estate). Loan positions naturally carry much lower capital charges than owning the real estate, and covered bonds carry even lower capital charges

It is quite impossible to justify the relative position of even the safest CMBS bonds under Solvency II as outlined above. It sends a very clear, and quite bizarre, message to European insurers seeking CRE and/or CRE debt exposure: buying CMBS is the absolute worst way to do it, regardless of the liquidity and risk diversification benefits that CMBS can offer insurers as compared to whole loan origination, and regardless of how well structured (simple, transparent, etc.) the specific CMBS transaction may be. From a broader investor perspective, taking insurers out of the CMBS market can only reduce the size and liquidity of the securitised CRE debt market for others.

Q12. Given the particular circumstances of the EU markets, could there be merit in advancing work at the EU level alongside international work?

This very much depends on the quality of the work. If Solvency II were to represent the standard of EU work, we would say "no". If on the other hand EU work took an intelligent, informed, asset class-sensitive approach and sought to avoid certain pitfalls affecting international work while seeking to maximise international alignment, we would say "yes".

The development of consistent rules internationally, as well as between overlapping existing national and member state regimes, would be highly valuable. It is imperative that different well-intentioned regulatory initiatives developed on either a national, European or international level are not developed in separate silos that inadvertently give rise to odd relative outcomes. Better international alignment of rules could limit the extent to which regulatory reform in the EU might put EU banks and other regulated investors at a competitive disadvantage. It could also reduce the vulnerability of the EU market to distortive inbound capital flows because other jurisdictions are regulating less effectively. International consistency should also limit the room for other forms of regulatory arbitrage, such as securitisation bonds being booked in a jurisdiction different from the location of the collateral.

From the point of view of CMBS (as with any other asset class), policymakers should encourage advancing work at the EU level alongside international work to improve both the structure and nature of the CMBS market and industry and the regulatory framework that applies to it. Whilst certain recommendations may be focused at a European level, there is much that could valuably be implemented internationally. On a national, European and international level, policymakers should 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).

Appropriate international coordination could benefit the CMBS market by increasing the size and liquidity of the market through expansion of the investor base internationally; and that in turn should facilitate dispersal of CRE exposure from systemically important banks to other investors.

Q13. Are there wider structural barriers preventing long-term institutional investors from participating in this market? If so, how should these be tackled?

We would very much like to see a market in securitised CRE debt that is more geared to the specific requirements of long-term institutional investors. That is the position in the US market, where there is a strong pipeline of longer-tenor, fixed rate CRE loans going into securitisation conduits for distribution to insurers and pension funds. Unfortunately, Solvency II has probably made the evolution of European CMBS markets in that direction impossible for the foreseeable future.

European CMBS comprises a mixture of issuance by investment banks which originate with a view to distributing some or most of the exposures originated, and issuance by commercial banks seeking to recycle capital. We understand that banks are strongly discouraged by their funding base and by regulation from holding loans with a tenor exceeding five years, so they would require a very certain non-bank distribution pipeline to originate loans that might appeal to long-term institutional investors.

At the same time, many borrowers prefer short-term loans given the lower potential prepayment penalties as the duration of the interest rate fixing is short. Europe lacks the infrastructure, culture and pricing advantages that make longer-term securitisable CRE loans work so well in the United States. In the meantime, we would strongly recommend a reconsideration of the regulatory barriers, especially those in Solvency II that make CMBS entirely uneconomic for European insurers.

Q14.A. For insurers investing in qualifying securitised products, how could the regulatory treatment of securitisation be refined to improve risk sensitivity? For example, should capital requirements increase less sharply with duration?

The treatment of securitisation in Solvency II is highly problematic. Below, we make some suggestions as to how risk sensitivity might be improved for Type 1 exposures (currently defined as senior bonds of certain asset classes) and for senior bonds of Type 2 exposures. In our response to Q14.B, we set out our proposals for improving risk sensitivity for mezzanine bonds of all exposures.

Risk sensitivity of Type 1 exposures (senior bonds of certain RMBS and ABS (including SME ABS))

As proposed, Type 1 securitisation exposures attract capital charges which are a multiple of those for comparable investments (AAA RMBS capital charge per duration year is three times higher than that for AAA covered bonds and 2.3 times higher than that for AAA corporate bonds). This should be more aligned to reduce the differences between securitisation and covered bonds, for example. As it stands, insurers will be heavily disincentivised to invest in Type 1 securitisation bonds, defeating the policy goal of promoting securitisation as a way to increase non-bank funding of the real economy in Europe.

The capital charges for AAA/AA/A/BBB rated Type 1 exposures are not risk sensitive enough, in fact the capital charges for AA, A and BBB rated bonds are the same (3% for year of duration) and that for AAA is only slightly lower (2.1%). We think that compared with other bonds (corporate, covered, loans) the BBB capital charge for Type 1 exposures is fairly set, but for higher rated securitisation bonds they are considerably too high. The annual charges for AAA, AA, A bonds should be reduced, increasing risk sensitivity for differently rated bonds and bringing charges closer to those of other investments.

Securitisation is the only asset class that does not have declining marginal capital charges for longer durations. This should be aligned with other investments.

As proposed, a securitisation bond would lose its Type 1 status if downgraded from BBB to non-investment grade. As a result, the annual capital charge would increase from 3% to 100% (i.e. by 33 times). In practice as the duration of the downgraded bonds would likely be more than one year, the multiple of increase may be lower (15-20 times) but still substantial. It is difficult to justify such an extreme cliff-edge. We would recommend a combination of bringing non-investment grade bonds into Type 1 and reducing the capital charges for Type 2 exposures.

The capital charges for Type 1 securitisation exposures compare unfavourably with capital charges for the underlying loans. For example, a 70% mortgage loan will have a capital charge of 2.5% (irrespective of duration) whereas a AAA RMBS senior bond capital charge is 2.1% for each duration year. It seems likely that insurers will not be allowed to consider call options for calculating duration, in which case RMBS senior bonds may be treated as having very long durations. The capital charge could be as high as 21%, nearly ten times higher than for the underlying mortgages, despite the lower credit risk (in the light of credit enhancement on securitisation, where the LTV is often 40-45%). As a result, Solvency II will result in insurers investing increasingly in loan portfolios, driven to sacrifice the liquidity benefits of RMBS by regulation.

The same holds true for other asset classes that qualify for Type 1 treatment. SME loans attract a capital charge of 3% per year of duration if unsecured, which could reduce to 1.5% for secured loans (SME loans are more often secured than not). For a portfolio of five year secured SME loans the capital charge would be 7.5%, compared with 10.5% for AAA SME ABS bonds benefiting from credit enhancement (lower credit risk) and higher liquidity.

We recommend that the capital charges for Type 1 securitisation exposures be reduced to align more closely with those for the underlying loans. It is not clear whether EIOPA deliberately sought to incentivise insurers to prefer investing in loans directly rather than in securitisations of such loans. If, as we suspect, Solvency II encourages insurers to prefer short dated Type 1 securitisation exposures (fast pay RMBS or auto ABS, for example) and to stay clear of most others, that would seem to run counter to the policy objectives of CMU as regards securitisation and institutional investors in the economy.

Risk sensitivity of Type 2 senior bonds

The blanket exclusion of CMBS from Type 1 is wrong. Many conservatively structured CMBS securitising high quality, low leverage, CRE loans should be able to qualify.

For senior bonds of Type 2 asset classes (including CMBS) the annual capital charges are excessive and lack any risk sensitivity. Irrespective of the rating for all senior securitisation bonds in the Type 2 bucket the capital charges will be in the 60-100% range, depending on duration (closer to 60% for CMBS and 100% for long dated RMBS, for example). Due to the lack of risk sensitivity (as capital charges for lower risk bonds are already close to the maximum) if insurers were to remain involved in senior Type 2 asset classes, Solvency II would incentivise them to buy higher-risk bonds which have higher returns (non-investment grade rated) – hence, Solvency II promotes risk taking in this respect. However, the charges are so high we suspect the likelier result is simply to end demand from EU insurers for senior Type 2 securitisation exposures.

Solvency II incentivises insurers to invest in CRE loans directly, regardless of their higher risk and lower liquidity relative to senior CMBS bonds. For example, a five year 75% LTV loan attracts a capital charge of 7.5%. A five year senior AAA CMBS bond (LTV usually around 40%) attracts a capital 62.5% capital charge, 8.3 times higher, despite the lower risk. The five year senior AAA CMBS bond attracts a substantially higher capital charge even than ownership <u>of the underlying real estate</u> (25%) which is in our view quite impossible to justify. It is surely necessary to revisit the capital charges contemplated by Solvency II having regard to the relative charges not only within securitisation asset classes, but between securitisation exposures and relevant exposures of different kinds.

Q14.B. Should there be specific treatment for investments in non-senior tranches of qualifying securitisation transactions versus non-qualifying transactions?

We have discussed Type 1 securitisation exposures and senior Type 2 exposures in our response to Q14.A. Here we focus on non-senior Type B exposures.

Non-senior tranches of securitisations (whether qualifying or not) enable credit risk transfer and capital relief for the originating bank. If it is not possible to place non-senior tranches, securitisation will not work to remove credit risk from the banking sector to the non-bank sector. Solvency II in its current form makes non-senior bonds very unattractive for European insurers.

Under EBA guidance, time call options are not allowed if a bank wants to gain significant risk transfer (and we suspect EIOPA will similarly not allow time call options to be taken into account when determining the duration of a securitisation bond). As a result the duration of non-senior bonds will increase (ironically, it will be lower for portfolios with balloon exposure) and in most cases the capital charge for non-senior bonds will be 100%. As it stands, insurers will not invest in non-senior bonds after Solvency II is in force.

Insurers might continue to invest in non-senior bonds that offer a return above their yield target or cost of equity (i.e., 4.5%-7%). Considering the capital charge of non-senior securitisation bonds will be close to or at 100%, investment grade non-senior bonds on sectors earmarked for qualifying securitisation treatment will likely not be able to offer these returns as at these levels the securitisation would not be viable (unless interest charged to borrowers increases significantly). The lack of risk sensitivity of non-senior bonds capital charges (capital charges are close to or at 100% irrespective of rating and place in the capital structure) could promote risk taking from insurers, encouraging them to pick the highest yielding bonds (low or non-investment grade rated non-senior bonds of non-qualifying securitisations) as these provide the highest and/or acceptable return on capital. This presumably unintended result could be reinforced by these non-qualifying sectors becoming the sectors (for example, leveraged loan CLOs or non-conforming RMBS) with ongoing supply as for qualifying securitisations the required yield levels are unviable to issue.

In CRE lending and CMBS, the treatment of non-senior bonds differs substantially from that of non-senior loans. Five year mezzanine loans (say 60% attachment LTV and 75% detachment LTV) attract a capital charge of 7.5%, the same as senior loans, despite the higher risk. Mezzanine CMBS bonds with the same LTV levels would likely be rated BBB or below and attract a 100% capital charge. The signal to insurers that they should invest in the loan not the CMBS is very clear.

For these reasons, capital charges for non-senior bonds need to be reduced substantially for all securitisations (Type 1/qualifying and Type 2/non-qualifying), in our view. Those of qualifying securitisation should be reduced more than those for non-qualifying to create risk sensitivity.

Q15.A. How could the institutional investor base for EU securitisation be expanded?

We would strongly support any action that can be taken to expand the investor base for not just CMBS but all forms of CRE debt. The major barrier is ill-conceived regulation, most strikingly typified by the proposed capital framework under Solvency II, which makes it cheaper to own a building than hold the most senior tranche of securitised debt secured on it. European CMBS cannot hope to follow US CMBS on the path to recovery and a diverse institutional investor base without better European regulation.

Q15.B. To support qualifying securitisations, are adjustments needed to other EU regulatory frameworks (e.g. UCITS, AIFMD)? If yes, please specify.

We do not have specific suggestions in response to this question, but the general approach of regulators is very important. Existing rules already contemplate differentiated capital requirements having regard to the extent to which a particular institution is systemically significant, even within a single type of regulated entity. Different types of differently regulated financial institutions operate in the CRE lending space alongside their other activities. Regulators need to be mindful of the overall picture, recognising that a regulatory treatment that makes sense in one context may create regulatory inconsistencies in another. Regulation can distort an organisation's allocation of capital (towards or against CMBS investing), or it can privilege one type of market participant over another, or one form of exposure over another. Whether regulation is deliberately seeking to influence behaviours or not, the consequences may not always be intended or desirable. Faced with regulatory arbitrage opportunities, capital providers and banks and other intermediaries will often prefer the cheapest, least regulated route, such that systemic risk builds up outside the regulator's field of vision. There is no simple solution to this problem, but regulators need to be aware of it, so that they periodically look up from the particular types of institutions they regulate to see the bigger picture.

Regulatory differences will often play a role in the participation levels of different types of investor in any market, so it might be helpful for regulators to have tools enabling them to encourage or discourage particular types of investor to participate in CMBS. Market data, expertise and analysis (such as regulators seem not currently to enjoy in relation to CRE debt markets) would be a good foundation for a holistic, sector-focused perspective, itself facilitating communication across regulatory teams and more effective use of regulatory differentiation to promote financial stability and a well-functioning and diverse market. See *A Vision for Real Estate Finance in the UK*, referenced above and uploaded with this response.

Q16.A. What additional steps could be taken to specifically develop SME securitisation?

Many SMEs rely on the ability to give security over the commercial premises they own and occupy to raise finance. However, the lending market for small businesses with smaller CRE assets in smaller towns and cities is often limited, with only a handful of local banks lending. An active and healthy CMBS market is the only realistic way to attract other sources of capital and to widen the range of products on offer beyond those that make regulatory sense for those banks. If CMBS is routinely excluded from any European qualifying securitisation label (as is the case under Solvency II and as would be the case based on the criteria proposed by the EBA), the effect will be to constrain the availability and increase the cost of credit for many of Europe's SMEs.

Q16.B. Have there been unaddressed market failures surrounding SME securitisation, and how best could these be tackled?

N/A

Q16.C. How can further standardisation of underlying assets/loans and securitisation structures be achieved, in order to reduce the costs of issuance and investment?

N/A

Q16.D. Would more standardisation of loan level information, collection and dissemination of comparable credit information on SMEs promote further investment in these instruments?

N/A

Q17. To what extent would a single EU securitisation instrument applicable to all financial sectors (insurance, asset management, banks) contribute to the development of the EU's securitisation markets? Which issues should be covered in such an instrument?

In principle we would strongly support a single EU securitisation instrument that is applicable to all financial sectors – but only if the instrument is appropriately calibrated to avoid discriminating against particular asset classes based on their inherent characteristics. CMBS is quite different from most other ABS asset classes, and certain principles that may seem obviously sensible 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 large, well-functioning European securitisation market for CMBS is part of the solution to the challenges posed by CRE debt to market participants and financial stability; regulation must not treat it as part of the problem.

Q18.A. For qualifying securitisation, what else could be done to encourage the further development of sustainable EU securitisation markets?

Credit quality should be irrelevant to the qualifying securitisation criteria. We strongly support an appropriately calibrated qualifying securitisation label that incentivises best practice in the securitisation market. Eliminating unnecessary complexity, ensuring high levels of transparency and encouraging standardisation and comparability (on a basis that is sensitive to the particular characteristics of different ABS sub-sectors) are all good goals. However, automatically excluding exposures falling below a specified credit standard from such a framework would remove the regulatory incentive for simplicity and transparency that would facilitate investor due diligence for precisely those investments most deserving careful scrutiny.

A more rational approach would be to give better regulatory treatment to <u>any</u> securitised exposure that meets appropriate qualifying criteria (regardless of credit quality) than <u>the same</u> exposure would attract if it did <u>not</u> meet those criteria. That would encourage simplicity, transparency and best practice generally across the securitisation market without distorting capital flows to entire parts of the real economy (whether by reference to credit quality or by reference to particular sub-sectors).

Q18.B. In relation to the table in Annex 2 are there any other changes to securitisation requirements across the various aspects of EU legislation that would increase their effectiveness or consistency?

See response to Q15.B.

We hope our submissions are helpful and would be delighted to discuss them with you in further detail at your convenience.

Yours faithfully

Peter Cosmetatos
CEO, CREFC Europe
pcosmetatos@crefceurope.org
+44 20 3651 5696