

Response to the BCBS Consultative Document *Capital treatment for “simple, transparent and comparable” securitisations* (issued in November 2015 for comment by 5 February 2016)

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

CREFC Europe is a trade association promoting a diversified, sustainable and successful commercial real estate (**CRE**) debt market in Europe. We believe that securitisation has an important part to play as a component of that market. 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.

Executive summary

1. We agree with the objective of promoting sustainable securitisation markets – both to rekindle credit flows and to diversify risks – and note that this is in particular important as regards credit serving the CRE industry. We also agree that the financial sector should be encouraged to develop simple and transparent securitisation structures meeting appropriate criteria, and that beneficial capital treatment for qualifying securitisations would be an appropriate and effective way of incentivising that.
2. However, we are concerned that certain of the additional criteria proposed will inevitably operate to exclude securitised CRE debt (in the form of commercial mortgage backed securities (**CMBS**)) from the scope of STC securitisation. Such an outcome would not serve the policy objectives of BCBS and would further damage the cause of better transparency, comparability and assessment and allocation of CRE risk in the financial sector. That is especially the case in Europe, where very visible weaknesses with pre-crisis CMBS issuance have distracted regulators from focusing on the far greater, but less visible, problem of poor CRE lending late in the property cycle, concentrated within the banking system.
3. We respond to certain of the questions in the CD and comment on the proposed criteria below. Our key points are summarised in the Appendix, by reference to the mistakes that we fear both BCBS and the EU, in its parallel STS securitisation proposals, seem likely to make.

Responses to the questions

Q1. Do respondents agree with the rationale for introducing STC criteria into the capital framework? Are there any other aspects that the Committee should consider before introducing STC criteria into the capital framework that are not already reflected in the rationale above?

We agree with the rationale for introducing STC criteria into the capital framework. We would encourage the Committee to acknowledge that a one size fits all approach across securitisation asset classes is not necessarily appropriate. For example, CMBS should be analysed in its functional context, i.e. as a small but potentially important component of the CRE debt market, which is far more transparent, comparable and tradable than the majority of that market. The criteria should encourage best STC practice across securitisation asset classes, rather than being configured in such a way as effectively to exclude so crucially important a factor of production as CRE from securitisation debt markets.

Q2. Do respondents agree that, for the purpose of alternative capital treatment, additional criteria are required? What are respondents' views regarding the additional criteria presented in Annex 1?

We have no objection to additional criteria for the purposes of alternative capital treatment, provided their focus and effect is clearly related to considerations appropriate for differentiation in regulatory capital requirements. In relation to securitised CRE debt, that is not the case for all of the proposed additional requirements, so we would recommend some recalibration.

Certain of the proposed additional criteria are simply incompatible with the structure of CRE credit markets, and in one case (D16, concentration limits) are fundamentally misconceived in relation to this asset class. If the Committee wishes to promote STC securitisation for the benefit of the whole real economy and the financial system at large, it should reconsider the application to CRE debt securitisations of the following additional criteria.

- (a) **D16: Granularity of the pool.** The proposed condition that no single exposure/obligor should represent more than 1% of the underlying pool seems appropriate for granular portfolios of retail financial products, but it makes no sense at all in the CMBS context. CRE loans are usually non-recourse to the borrower – investors' credit risk is on the tenants liable to pay rent under leases, not on the borrowers. If diversification of credit risk is felt to be important (and that case has not been made in relation to CMBS), it needs to be at the tenant level. Indeed, a single underlying borrower can be beneficial, because it would typically allow the cash flows from different leases and CRE assets within the pool to be cross-collateralised (something that is obviously not possible where they belong to different borrowers). This criterion should be disapplied in relation to CRE debt.
- (b) **D15: Credit risk of underlying exposures.** It is proposed that no commercial mortgage loan in the pool must have a risk weight under the Standardised Approach of more than [50]%. That is entirely inappropriate, because it would serve simply to exclude CRE debt from STC securitisation: the normal risk weight for CRE loans is 100%. Even the proposed revisions to the Standardised Approach would introduce minimum risk weights of 80% for income-producing CRE and 60% for 'other' CRE. It would of course be possible to explore ways of controlling for credit quality or promoting consistent underwriting standards in the context of CRE debt, and we would be happy to contribute to any such discussion – but there has been no such effort on the part of regulators.¹
- (c) **D17: Relationship between the originator and the servicer of the securitised assets.** The proposed requirement that the originator and servicer should exempt relevant commercial as well as residential mortgage securitisation markets. There is a professional and sophisticated third party servicing sector in the CMBS context which works well. While there have been issues around loan servicing in pre-crisis CMBS, this criterion is not the best way to address them – the industry has already responded to the challenge, including through CREFC Europe's [Market Principles for Issuing European CMBS 2.0](#).

If this criterion is appropriate at all, it should be disapplied in the case of “residential and commercial mortgages in a jurisdiction where it is common practice to employ a third party servicer”, subject to the same condition that the servicer “should be widely recognised in the industry for its residential or commercial (as the case may be) mortgage servicing excellence” [emphasis added to highlight new wording].

¹ The CRE industry in the UK, by contrast, has set out a framework for further work in this area, in the May 2014 report *A Vision for Real Estate Finance in the UK*, available at: <http://www.ipf.org.uk/industry-involvement/a-vision-for-real-estate-finance-in-the-uk.html>.

- (d) **A2: Asset performance history.** It is important to recognise that certain large, heterogeneous types of exposure do not lend themselves to statistical analysis. Investors in CMBS typically focus their due diligence on the specific subject-matter of a transaction, because it is difficult to draw meaningful and reliable inferences about performance from “substantially similar” exposures.

While it is plainly important that the originator/sponsor of the securitisation and the original lender (if different) should have appropriate experience and expertise, we would warn against laying down specific criteria for assessing the sufficiency of their track records. It might be more appropriate for the criterion to lay down requirements relating to how track record is disclosed to prospective investors, particularly if the rules are not to operate as a barrier to the entry of new participants to the market.

In addition, we would like to comment on one of the criteria previously proposed, on which regulatory thinking appears to be evolving, because of its importance from the CRE debt perspective.

- (e) **B7: Redemption cash flows.** The proposed wording of this criterion is open to interpretation that could be helpful or unhelpful from the point of view of the securitisation of CRE debt. Refinancing risk is a risk for all European CRE debt (not only the small part of it that is securitised), because the CRE debt market is, in general, a bullet repayment market with no (or relatively modest) amortisation during the term of loans which, when originated by the traditionally dominant banking sector, would not normally have a term of more than five to seven years.

Refinancing risk is specifically a cyclical risk because of the strong feedback loops between the property cycle and the credit cycle, and the historic tendency of regulators to act on the CRE debt market in a pro- rather than counter-cyclical way. The last boom demonstrated how lending volumes increased, margins and covenant protection fell, and regulators and policymakers failed to sound the alarm or to ensure that banks built up adequate capital as the peak of the market approached. When the crisis struck, CRE debt exposure in Europe was overwhelmingly concentrated on the balance sheets of certain banks, with only a modest amount having been securitised.

The fact that it is far easier to observe the performance of securitised CRE debt than that of CRE debt retained on bank balance sheets does not mean that problems relating to redemption cash flows are a function of securitisation. They are not. Imposing a “high quality” securitisation criterion that is incompatible with the underlying CRE debt market will not help to reduce refinancing risk in that underlying market. It is more likely to lead to poorer visibility about the scale and nature of that risk, and about where it lies. Addressing this issue by excluding CRE debt from STC securitisation is more likely to add to systemic risk associated with CRE debt than to reduce it.

Refinancing risk should be addressed at the level of the underlying CRE lending market, through a combination of better information and transparency, better understanding of cyclical risk among market participants and regulators, and structurally counter-cyclical regulation. *A Vision for Real Estate Finance in the UK*² contains a thorough analysis and makes specific recommendations for doing that. The Bank of England has expressed support³ for certain of that report’s recommendations, but their relevance is by no means limited to the UK market.

² This independent UK industry report is available at: <http://www.ipf.org.uk/industry-involvement/a-vision-for-real-estate-finance-in-the-uk.html>.

³ See the October 2015 speech of Alex Brazier, Executive Director for Financial Stability Strategy and Risk, available at: <http://www.bankofengland.co.uk/publications/Pages/speeches/2015/850.aspx>.

We would recommend a more flexible approach that emphasises information rather than hard and inflexible requirements. Specifically, issuers could be required to provide prospective investors with a comprehensive and contextualised explanation of how refinancing risk has been managed and mitigated, through the structure of the underlying loans (LTVs, amortisation, etc.) and through the structuring of the securitisation itself (tail period between loan maturity and legal final maturity of the bonds, etc.). More modestly, the simplest point would be to recognise – in line, indeed, with post-crisis market practice – that longer tail periods between loan maturity and legal final maturity of the bonds mean that the underlying assets “do not need to be refinanced over a short period of time” [emphasis added].

Q3. What are respondents’ views on the compliance mechanism and the supervision of compliance presented in this consultative document?

We have no submissions on this question, but are generally supportive of, and refer you to, the submissions of GFMA, especially as regards the need for mutual recognition to support securitisation and investment in securitisation internationally.

Q4. What are respondents’ views on the alternative capital requirements for STC securitisation presented in this consultative document?

We have no submissions on this question. We would be supportive of GFMA’s arguments in favour of greater benefits for STC securitisation if the criteria (including the additional criteria) were recalibrated so as to encourage STC features across all ABS asset classes, rather than effectively excluding CRE.

We are at your disposal should you wish to discuss any of the points made in this submission.

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Qualifying securitisation criteria and commercial real estate finance / CMBS

Sustainable and responsible securitisation markets have an important role to play in the commercial real estate (CRE) debt market, as they do in other parts of the financial system. Unfortunately, the criteria that international regulatory bodies have been developing to encourage simple and transparent securitisation ignore key aspects of the CRE debt market. As a result, an important opportunity to improve the resilience and diversity of CRE debt markets is likely to be missed. Here are the key points.

CRE (and CRE finance) is a key part of the real economy. CRE debt serves a functionally essential, enabling part of the economy – the CRE investment and development industry. That industry provides quasi-financial services to ordinary businesses – the ability to rent space flexibly is especially important for new and growing businesses. It is also an important investable asset class alongside fixed income and bonds. For the most part, CRE investors and developers can only provide space for occupiers and maintain our urban infrastructure if their risk-taking equity is combined with cheaper, lower-risk debt.

CRE debt (not CMBS) can pose risks to financial stability. As the recent financial crisis showed, there can be feedback loops between the property cycle and the credit cycle, with a threat to financial stability if lenders drive values up and over the peak, only to find themselves saddled with large distressed loan books that take years to resolve. But simply discouraging the flow of credit (or capital more generally) to CRE is not the right answer, because of the adverse impact on the quality and cost of premises available to business and the quality of our built environment more generally. A more CRE-literate approach was proposed by the independent UK Real Estate Finance Group in its May 2014 report, [A Vision for Real Estate Finance in the UK](#), which makes seven (mostly geographically transferable) recommendations for protecting financial stability while allowing a sustainable flow of credit to the CRE sector across the cycle.

An evolving CRE lending and debt-investing universe. In recent times, CRE lending has been the preserve of the banks in Europe – leading to concentration risk and a lack of transparency or liquidity that continues to afflict Europe’s financial system and economy. However, investors have long understood the attraction of CRE debt, which provides stable, long-term income with an illiquidity premium over larger segments of the fixed income universe, as well as security over income-producing physical assets. While the return of European banks to new origination is essential, it is surely in Europe’s interests to promote a more diverse CRE debt market for the future.

A brief history of European CMBS. Before the crisis, Europe was beginning to follow in the steps of the United States, developing a CMBS market that could allow non-originating investors to gain exposure to CRE debt in a more liquid form, with far greater transparency and diversification potential than other products could offer. While some CMBS issues suffered rating downgrades, defaults and, in a few cases, losses during the crisis, CMBS was in fact almost irrelevant to the CRE-related vulnerabilities of Europe’s financial system. On the contrary, it provided a mechanism for risk transfer and dispersal, some degree of liquidity in an inherently illiquid asset class, and transparency and data in a fundamentally private and opaque asset class. While pre-crisis CMBS had shortcomings, the crisis presented an opportunity for them to be identified and addressed, and the industry did just that, including through the development of CREFC Europe’s [Market Principles for Issuing European CMBS 2.0](#) (whose recommendations have generally been incorporated in post-crisis issuance).

CMBS as part of the solution. CMBS currently accounts for less than 5% of the European CRE debt market, and new issuance post crisis has been at very modest levels. Most non-bank investors have sought exposure to CRE debt by setting up their own origination platforms, making allocations to specialist fund managers, using joint ventures or participating in the syndication market. While that diversification is welcome, it is unfortunate that regulatory hostility to CMBS is driving capital to favour direct exposures over CMBS. CMBS has unique attractions over direct CRE lending, such as better risk diversification and secondary market liquidity, the existence of comparable performance data, and the

discipline of the rating process. The way to protect banks, non-originating investors and financial stability is not to punish CMBS. Indeed, for EU insurers and other investors, there is a great deal to be said for investing in low risk CRE debt through senior CMBS exposures than through (often higher leverage) whole loans. Broader CRE debt market risks should be addressed by regulators and industry together taking forward the proposals for greater informational transparency, diversification and counter-cyclicalities recommended in [A Vision for Real Estate Finance in the UK](#).

Why don't qualifying securitisation criteria accommodate CMBS? Efforts to revitalise simple and transparent securitisation should be recalibrated so that securitised CRE debt is not excluded altogether. The criteria should be designed to incentivise the CRE debt securitisation market to meet appropriate standards for simplicity, transparency and (to the extent reasonably achievable in a fundamentally heterogeneous asset class like CRE) standardisation/comparability. The main problems with the criteria currently proposed are as follows.

- (a) **Concentration limits (Article 243(2)(b) of the proposed CRR amendment regulation; new BCBS STC criterion D16).** The proposed condition that no single exposure/obligor should represent more than 1% of the underlying pool makes no sense at all in the CMBS context. CRE loans are usually non-recourse to the borrower – investors' credit risk is on the tenants liable to pay rent under leases, not on the borrowers. If diversification of credit risk is felt to be important (and that case has not been made in relation to CMBS), it needs to be at the tenant level. Indeed, a single underlying borrower can be beneficial, if it means that the cash flows from different leases and CRE assets are cross-collateralised (as they cannot be where they belong to different borrowers).
- (b) **Credit quality (Article 243(2)(c)(ii) of the proposed CRR amendment regulation; new BCBS STC criterion D15).** It is proposed that no commercial mortgage loan in the pool must have a risk weight under the Standardised Approach of more than 50%. That is inappropriate, because it would serve simply to exclude CMBS: the normal risk weight for CRE loans (which are typically non-recourse and to unrated borrowers) is 100%. It would of course be possible to explore ways of controlling for credit quality in the CMBS context, and we would be happy to contribute to any such discussion – but there has been no such effort on the part of regulators.
- (c) **Refinancing risk (Article 8(9) of the proposed securitisation regulation; BCBS STC criterion B7).** The Commission's proposal adopted a very sensible form of words on this point, requiring that repayment to investors should "not depend, substantially, on the sale of assets securing the underlying exposures". The BCBS criterion also adopts a relatively flexible approach. This is a genuine risk area for CMBS, and it is right that a test should apply to control for how it has been managed. However, regulators must resist a crude approach that rejects any refinancing risk, as that is simply incompatible with the underlying CRE debt market, and fails to recognise how refinancing risk can be managed and mitigated.⁴
- (d) **Fiduciary standards (new BCBS STC criterion D17).** The proposed requirement that the originator and servicer should exempt relevant commercial as well as residential mortgage securitisation markets. There is a professional and sophisticated third party servicing sector in the CMBS context which works well. While there have been issues around loan servicing in pre-crisis CMBS, this criterion is not the best way to address them – the industry has already responded to the challenge, including through CREFC Europe's [Market Principles for Issuing European CMBS 2.0](#).

⁴ We are especially troubled by the EBA's earlier proposal that loans must be fully self-liquidating, and by the European Council's proposed inclusion of a recital (19a) explicitly stating that because of refinancing challenges facing some CMBS during the crisis, CMBS should simply be excluded from STS securitisation (a sorry return to the asset class-by-asset class approach of Solvency II). The Commission's approach is very much to be preferred.