

Response to EBA discussion paper on ‘simple standard and transparent’ securitisation

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

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

Executive summary

We 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 policy objectives outlined and endorsed above 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 EBA’s criteria are capable of being satisfied by CMBS, having regard to the structure and logic of the wider CRE debt market. A number of the criteria proposed (while well-intentioned) fail that test, so their application to CMBS should be reconsidered. The DP shows a willingness to make pragmatic, targeted exceptions from proposed criteria in the light of the characteristics of other ABS asset classes¹ – it should do so for CMBS as well.²

More generally, we would remind the EBA that securitisation represents only a small part of the European CRE debt market. 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*³ 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).

The EBA should not use credit criteria to close off the regulatory benefits of meeting those criteria for riskier investment propositions, because doing so will remove the incentive for large parts of the securitisation market to strive to meet simple standard and transparent criteria.

A sensible regulatory framework for CRE debt securitisation 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. Please let us work with you to support the development of criteria that are both effective and compatible with the CRE debt market.

¹ For example, in relation to the securitisation of personal overdraft facilities and credit cards, where “common practice justifies an exception from the operation” of proposed Criterion 6.

² For example, a criterion that loans are full recourse to an individual or non-special purpose corporate borrower is wholly incompatible with the underlying CRE and CRE financing market, while not making “enforceability more complex” in the context of that market. Accordingly, it should not be applied to CMBS.

³ See https://www.ipf.org.uk/home/vision_for_real_estate_finance/default.aspx.

Appendix: detailed comments on the DP

Executive Summary

The Executive Summary frames the discussion in terms of the “risks” and “shortcomings” of the securitisation market. There is no recognition of securitisation as a risk **mitigant** (although that is principally what it is in the CRE debt context). Did the EBA conduct any comparison of the performance of securitised CRE debt against that of CRE debt of similar vintage that was originated for bank balance sheets (where most European CRE lending activity has traditionally been concentrated)? We suspect such a comparison would show that the securitisation process generally did more to **reduce** risk for CRE loan originating banks (albeit some investors may have been exposed to more risk than they thought) than it did to “create additional model risk and agency risk” (p52 of the DP).

It is also not clear from the DP whether the EBA fully considered the different types of CRE debt securitisation. Counter-intuitively, a number of the criteria would (among other things) impose worse treatment on one type of transaction (agency securitisation)⁴ that tends to perform very well.

As explained in our comments on Recommendation 4, we disagree with the aim “limiting the extent of non-neutrality of capital charges” **only** for ‘qualifying’ securitisations. We believe that the better approach would be for:

- the capital treatment of **all** securitisations to limit the extent of non-neutrality of capital charges,
- but for securitisations that do **not** meet appropriately calibrated ‘simple standard and transparent’ criteria to suffer a capital penalty relative to those that do meet them.

Appropriate calibration of the ‘simple standard and transparent’ criteria is important. Designing a privileged ‘qualifying’ securitisation label in a way that, in effect, simply excludes CMBS will not meet any of the policy objectives of promoting simple, standard and transparent securitisations, supporting the real economy or enhancing the resilience of the financial system. Instead, it will reduce the extent to which the CRE debt market uses securitisation (thereby reducing transparency and liquidity, as well as investor choice), and concentrate risk in different parts of the financial system (especially Europe’s banks).

State of the EU securitisation market

As noted above, we would encourage the EBA to compare CMBS performance data with performance data for unsecuritised CRE debt of similar vintage in order to contextualise CMBS performance in a more meaningful way than is achieved by comparing it only to other ABS asset classes.

⁴ 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 effectively secured corporate bond issues which rely on cashflows from the assets of the business in question. They are not a bank financing tool.

Regulatory reforms related to securitisation since 2009

In comparing securitisation and covered bonds, it is important to acknowledge one fundamentally important point. The fact that covered bonds are not intended to, and do not, disperse risk from the banking sector means that they are of their essence a funding tool for banks, and one whose performance is critically important to the stability of banking systems. Securitisation, on the other hand, transfers risk away from issuing banks, so the performance of securitisation bonds is not as systemically important as that of covered bonds.

The dual recourse nature of covered bonds inevitably affects how governments view them: the fact that banks are on the hook if the security fails to protect investors means banking systems are exposed and may need support. It also affects how investors approach them: the security pool, which is absolutely critical in securitisation, is backstopped by the bank itself and (investors might assume) by the taxpayer, for covered bonds.

The very different commercial and systemic functions and characteristics of securitisation and covered bonds cannot safely be reduced to a simple comparison of relative performance – and regulators considering differentiated treatment should be mindful of that.

Recommendation 1: Recommendation for a holistic (cross-product and sector) review of the regulatory framework for securitisations and other investment products

We strongly agree. It is a good idea to conduct a holistic (cross-product and sector) review of the regulatory framework for securitisations and other investment products. 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.

Likely impediments in the post-crisis EU securitisation market

Question 1: Do you agree with identified impediments to the securitisation market?

We broadly agree with the identified impediments. 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 counter-balanced by investor appetite for yield, which CRE debt-backed securities can provide in part thanks to their illiquidity premium.

In regulatory terms, we would emphasise that the problem is not limited to regulatory uncertainty (including around the precise scope of the regulatory definition of “securitisation”). It is also a matter of actual regulatory developments, such as the automatic “Type B” classification of CMBS under Solvency II.

Development of a simple, standard and transparent securitisation market

The DP makes reference (on p36) to a number of non-credit related factors that can have a significant impact on the performance of ABS in stressed conditions. We would like to comment briefly on some of them from the point of view of CRE debt markets.

- i. **Misalignment of interest/‘originate to distribute’.** During the crisis, CMBS generally performed much **better** than loans originated by European banks for their balance sheets. That demonstrates that poor underwriting during the boom was **not** a result of misaligned interests (and risk retention requirements would now mitigate the problem in any event, both for

qualifying and for non-qualifying securitisations).

Cyclical deterioration in underwriting standards should be addressed not in the context of high quality securitisation, but in the CRE lending market **generally**. Otherwise, bad CRE lending practices will be unchanged, but the risk will be even more concentrated in banks and other originating institutions. We believe there **is** a place for the 'originate to distribute' model in CRE debt markets, provided best practice is followed in terms of avoiding unnecessary complexity, providing good quality information to prospective investors, etc.

- ii. **Granular and diverse pools.** Obvious though the benefits of granularity and diversity may be in the context of consumer loan ABS, the position is very different in the context of CRE debt. Most CMBS investors will confirm that a securitisation backed by a single asset and a single borrower is much easier to analyse and due diligence than a securitisation backed by, say, 15 or 20 borrowers. Indeed, some of the best performing CMBS transactions are single asset, single borrower transactions (and many of those are agency transactions which, if they fall within the 'securitisation' definition, would be unable to satisfy a number of the EBA's proposed criteria).

Regulatory definitions of granularity typically focus on the number of borrowers, on the basis that borrowers present credit exposure so more borrowers means greater diversification. The CRE debt market is overwhelmingly a non-recourse market, in which the borrower or sponsor matters because of its skill as an asset manager, and credit exposure depends on the tenants who pay the rent that supports debt service. To illustrate the point, a loan to a single borrower may be highly diversified if it is secured on one or more shopping centres with dozens or hundreds of tenants (typically including a number of highly rated 'anchor' tenants).

A further point is that the same pool of collateral will be a more attractive proposition if it is owned by one or more connected borrowers than if each property is under commercially separate ownership. The reason is that a single borrower or borrowing group will typically provide cross-collateralisation across the security pool, reducing the risk of losses for investors compared to multiple ownership. Other things being equal, cross-collateralisation is far more valuable than apparent diversification at the borrower level.

- iii. **Leverage.** The EBA's discussion of the risks of leverage seems focused on model risk in the context of granular portfolios. In this as in many other areas, we are concerned that the DP does not adequately analyse heterogeneous, non-granular asset classes like CRE and CRE debt.
- iv. **Maturity transformation.** In the context of CMBS, it is important to understand that maturity transformation is embedded in the underlying CRE debt market, not in the securitisation process. Both the market and the credit rating agencies have learned from the crisis and are now using longer tail periods (as well as a closer focus on the affordability of debt from an income as well as capital repayment perspective) to mitigate the maturity transformation that is a structural feature of CRE debt.

Condemning CMBS to regulatory penalties because of structural features of the underlying credit market simply risks continuing the historic concentration of refinancing risk on European bank balance sheets.

- v. **Transparency.** While transparency can always be improved, the EBA should acknowledge that CMBS investors have generally enjoyed good levels of information regarding underlying assets and pricing. Real transparency challenges mostly exist in the underlying CRE debt market, which has traditionally been concentrated on European bank balance sheets. It is mostly thanks to securitised CRE loans that investors, market participants and observers and regulators had any meaningful visibility about what was going on in the CRE debt market during the crisis. It is

doubtful that, even after the Asset Quality Review and associated stress tests, the transparency of CRE debt on European bank balance sheets can rival the transparency of CMBS.

Recommendation 2: Recommendation to create a framework for simple, standard and transparent securitisations

We agree with this recommendation insofar as the aim is to encourage good structuring practice so that unnecessary complexity is avoided and due diligence by investors and analysts is made easier. We also agree that unnecessary “complexity and opaqueness” should be reduced and that there is, in broad terms, merit in encouraging a degree of standardisation of products. However, it is vital to recognise that there are limits to how far standardisation is either possible or desirable in the context of so heterogeneous an asset class as CRE debt.

We are however concerned at the binary nature of this approach, which seems entirely at odds with the stated rationale of “paving the way to a more risk-sensitive regulatory framework”. As discussed elsewhere in this response, we disagree that only the capital treatment for ‘qualifying’ securitisations that should aim at limiting the extent of non-neutrality of capital charges.

Recommendation 3: Recommendation on criteria defining simple, standard and transparent securitisations.

It is important to get the criteria right, if the policy objectives of the EBA are to be achieved. We see value in some of the proposed criteria, do not object to others, and regard a small number as fundamentally problematic from the perspective of the CRE debt market and the role securitisation can play there. We deal with them in turn below.

Pillar I: simple securitisations – Criterion 1 (*‘traditional securitisation’ and not ‘re-securitisation’*)

Subject to ironing out a number of questions regarding the scope of the CRR “securitisation” definition (specifically, relating to agency CMBS), we agree with this proposed criterion.

Pillar I: simple securitisations – Criterion 2 (*no discretionary active portfolio management*)

We have no objection to this proposed criterion for the simple reason that “active portfolio management on a discretionary basis” is not a feature of CRE debt securitisations. However, we would stress that CRE (and thus also CRE debt) is a lumpy and heterogeneous asset class, which is usually most appropriately and effectively analysed through asset-specific due diligence and not by statistical methods. This is not a market in which it is easy to lay down standard eligibility criteria. Accordingly, random selection of exposures would in the large majority of cases be entirely inappropriate.

Pillar I: simple securitisations – Criterion 3 (*legal true sale*)

Subject to ironing out a number of questions regarding the scope of the CRR “securitisation” definition (specifically, relating to agency CMBS), we agree with this proposed criterion.

Pillar I: simple securitisations – Criterion 4 (*homogeneous exposures, full recourse, no SPV borrowers, no refi risk*)

Certain elements of this complex and multifaceted criterion are highly problematic from the point of view of the CRE debt market and, as a result, for CMBS. While we are sympathetic to the rationale behind most of its elements, it needs to be reconsidered in relation to CMBS. Not only would failing to do that put the policy objectives behind the DP at risk, but a material danger of new systemic risk

build-up could be created in CRE debt markets. We consider the different limbs in turn.

- i) Arise from obligations with defined terms / rights to receive income from specified assets

We have no objection to this proposed criterion.

- ii) Consistently originated in ordinary course of business pursuant to uniform and non-deteriorating underwriting standards

We do not think this proposed criterion is appropriate, at least in the CMBS context. It implies that only securitisations originated by established lenders can be “simple” and that investors invest based on statistical analysis. That assumption is incorrect in the CRE debt context, and the effect would be to rule out securitisations without originators (such as agency CMBS, whose issue process is closer to that of corporate bonds)⁵. More generally, for concentrated and heterogeneous asset classes like CMBS, it is usual for a deal to involve only a small number of assets. As a result, asset level analysis is possible and realistic for most institutional investors, as well as more appropriate than statistical analysis. The inappropriateness of statistical analysis also means, of course, that the existence or performance of other exposures originated by the same originator will not generally be relevant.

- iii) Contain legal, valid and binding obligation

We agree with this proposed criterion.

- iv) Full recourse, not to a special purpose entity

This proposed criterion is not appropriate and should not apply in the context of CMBS. The CRE debt market is, especially in larger ticket sizes, overwhelmingly a non-recourse market, in which lenders’ exposure to the borrower is effectively limited to the borrower’s skills as an asset manager in respect of the CRE it owns, manages and lets out to rent-paying tenants. Especially for larger ticket CRE, it is unusual for tenanted land and buildings to be owned other than by a special purpose entity. That is a position that generally suits lenders, as it allows them to focus on the cash flows and risks of the assets without being concerned with broader business risks relating to the sponsor. Accordingly, this proposed criterion would not add “simplicity” to CMBS – it would more likely add complexity.

More generally, imposing this criterion for a privileged category of ‘qualifying’ securitisations would have little or no impact on the underlying CRE lending market, other than perhaps limiting the access of non-originating investment capital to it. If there are genuine risks associated with non-recourse, special purpose entity lending against CRE, the effect would be to ensure that those risks remain within the banking system. It is hard to see any benefit in that.

- v) No reliance on refinancing or sale

This proposed criterion needs to be reconsidered in the context of CMBS. We agree that refinancing risk can be significant in the context of CRE lending, owing to the highly cyclical nature of CRE markets and the positive feedback loops between the property cycle, the credit

⁵ And which are typically at the better performing end of the spectrum – see footnote 4.

cycle and the regulatory cycle. For a more detailed discussion of this problem, and suggested solutions, we refer you to *A Vision for Real Estate Finance in the UK*.⁶

A complete bar on refinancing risk for ‘qualifying’ securitisations is **not** part of the solution, however, because the CRE lending market would effectively ignore it. Lenders would continue to take refinancing risk, because the CRE lending market is overwhelmingly a non-amortising (or only partially amortising) market. With CMBS no longer affordable in regulatory capital terms for key investor types, distribution and risk transfer would likely be limited to the covered bond market, the syndication market and through investment funds. Inevitably, more of the refinancing risk would remain concentrated on the balance sheets of Europe’s CRE lending banks. We cannot see how such an outcome would promote the EBA’s objectives.

A better approach for tackling refinancing risk in the context of promoting ‘simple standard and transparent’ securitisations would be to require issuers to provide prospective investors with a comprehensive and contextualised explanation of how refinancing risk has been managed, both 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.)

Pillar I: simple securitisations – Criterion 5 (no disputes, defaults, credit-impaired borrowers)

We have no objection to this proposed criterion.

Pillar I: simple securitisations – Criterion 6 (at least one payment made by the borrower)

We note the EBA’s exclusion of personal overdraft facilities and credit cards from the application of this criterion because “common practice” in the way such securitisations are structured means they could not satisfy it.

To the extent that agency CMBS might fall within the scope of the “securitisation” definition, the same is also true of such transactions, so they too should be excluded.

Subject to that point, we have no objection to this proposed criterion, although the rationale behind it is not likely to be a relevant factor in the context of CRE debt securitisations.

Question 2: Should synthetic securitisations be excluded from the framework for simple standard and transparent securitisations? If not, under which conditions/criteria could they be considered simple standard and transparent?

While it is clear why synthetic transactions are tainted, it is our understanding that European RMBS, CMBS and other ABS have generally performed as expected, and we are not convinced that a blanket exclusion would be appropriate. Synthetic securitisations can be simpler than true sale transactions, particularly for cross-border investments where the complexity and challenges of dealing with Europe’s many different legal systems can be side-stepped. Subject to sensible requirements relating to transparency, information about the underlying loans, servicing procedures and managing conflicts of interest, we would have thought the simple standard and transparent regime should be capable of accommodating some synthetic transactions.

⁶ See https://www.ipf.org.uk/home/vision_for_real_estate_finance/default.aspx. You should note that the solutions proposed in this report focus on the CRE debt market as a whole, and not on the CMBS market, for the simple reason that the challenges presented by the cycle affect the CRE debt market as a whole: they cannot be addressed by regulating securitisation.

Question 3: Do you believe the default definition proposed under Criterion 5 (ii) above is appropriate? Would the default definition as per Article 178 of the CRR be more appropriate?

We agree with proposed criterion 5(ii)(a). However, proposed criterion 5(ii)(b) is unworkable in the context of CRE loans, because it appears to require that the underlying loans are underwritten on a full amortisation basis (so that there is no reliance on realisation of collateral). As explained elsewhere in this submission, the majority of CRE loans are not originated on a fully amortising basis (whether they are originated for bank balance sheets, for the covered bond market, for insurer balance sheets or for securitisation). Given the modest reliance of Europe's CRE debt market on securitisation, the effect of requiring full amortisation would simply be to exclude all CRE debt securitisation from the simple standard and transparent regime without reducing risk overall.

Question 4: Do you believe that, for the purposes of standardisation, there should be limits imposed on the type of jurisdiction (such as EEA only, EEA and non-EEA G10 countries, etc): i) the underlying assets are originated and/or ii) governing the acquisition process of the SSPE of the underlying assets is regulated and/or iii) where the originator or intermediary (if applicable) is established and/or iv) where the issuer/sponsor is established?

We would generally favour a global level playing field for securitisation, so would generally regard limits of this kind as unhelpful.

Pillar II: standard securitisations – Criterion 7 (*compliance with risk retention rules*)

Subject to ironing out a number of questions regarding the scope of the CRR "securitisation" definition (specifically, relating to agency CMBS), we would not object to this proposed criterion.

Pillar II: standard securitisations – Criterion 8 (*use of interest rate and currency hedging*)

We are sympathetic with this proposed criterion, but members have raised two particular concerns. First, the proposed restriction of permitted derivatives to those used "for genuine hedging purposes" risks having, as a main consequence, an increase in legal and accounting costs for the provision of opinions confirming the nature of the derivatives in place.

Secondly, while the use of industry standard documentation and definitions is usual, it is generally better to allow the industry to develop, maintain and change such standards rather than to risk hardwiring them through regulatory requirements.

Pillar II: standard securitisations – Criterion 9 (*no atypical rates or complex formulae or derivatives behind referenced interest payments*)

We are sympathetic to the aim of this criterion, but we believe that it strays into territory that may be better left to the market to address.

In particular, it is unclear how one determines where the boundary is between formulae or derivatives that are "complex" and those that are not. Perhaps the EBA could consider modifying the wording of this criterion so as more explicitly to accommodate the judgment that would surely need to be exercised (with potentially different results in different deals and market segments, and at different times).

Pillar II: standard securitisations – Criterion 10 (revolving period deals to provide for appropriate early amortisation/termination triggers)

We agree with this proposed criterion.

Pillar II: standard securitisations – Criterion 11 (sequential amortisation payment priority and no requirement for immediate liquidation following a performance related trigger, EoD or acceleration event)

In the context of CMBS, investors will often have a say in whether a transaction should be accelerated so they have the opportunity to express support for a restructuring or other remedy – such that sequential principal amortisation commences only after a note event of default and a noteholder vote to accelerate. That flexibility should be preserved.

Pillar II: standard securitisations – Criterion 12 (clear contractual provision for dealing with default or insolvency of servicer, hedging counterparty, liquidity facility provider)

We agree with this proposed criterion.

Pillar II: standard securitisations – Criterion 13 ('identified person' with fiduciary responsibilities who can resolve inter-class dispute based on clear contractual provision and with voting rights clearly defined and allocated to the most senior credit tranches in the securitisation)

While the aim of this proposed criterion is a reasonable one, we feel the EBA's approach is too prescriptive, and greater latitude should be allowed to the market to work out the best ways to manage tensions between the rights of different investors, having regard to the underlying asset class and to the characteristics and requirements of the particular transaction.

Historically, a trustee with fiduciary responsibilities is normally tasked with resolving disputes between different investor classes in a CMBS transaction. The arrangements have not always worked perfectly, and the legal test for trustees to act in the best interests of investors – without being CRE or CRE debt experts – is a standard that can be difficult (or even impossible) to satisfy with confidence. Post-crisis, the industry has been exploring how this and other elements of the securitisation process and the related documentation can be improved.⁷ We believe that process should be allowed (and encouraged) to continue.

We are concerned that regulatory hardwiring of particular solutions (especially of the "one size fits all" variety) would have distortive and unintended consequences. We would emphasise once again the heterogeneous and non-granular nature of CRE and CRE debt, and the consequently important and natural role that CRE specialist investors can play by taking junior notes that carry specific rights (clearly set out in the prospectus and underlying documentation) over work-out of non-performing loans or properties.

We would support a less prescriptive criterion, for example simply requiring that transaction documentation contain clear provisions for timely and effective decision-making in the best interests of investors in the securitisation and for the resolution of disagreements that might arise between different classes of noteholders, consistent with appropriate industry practice for particular asset classes.

⁷ See for example the Market Principles for Issuing European CMBS 2.0, published by CREFC Europe in November 2012 and available here: http://www.crefc.org/uploadedFiles/CMSA_Site_Home/Global/CMSA-Europe/Committees/European_CMBS_20_Committee/Market_Principles_for_Issuing_European_CMBS2.pdf.

Pillar II: standard securitisations – Criterion 14 (<i>demonstrable servicer expertise and well-documented policies, procedures and risk management controls</i>)
We agree with this proposed criterion.
Question 5: Does the distribution of voting rights to the most senior tranches in the securitisation conflict with any national provision? Would this distribution deter investors in non-senior tranches and obstacle the structuring of transactions?
As a result of the particular nature of CRE and CRE debt as a heterogeneous, concentrated underlying asset class, the CMBS market evolved to attract often very CRE-specialised junior noteholders by offering them relatively extensive rights over work-out and restructuring approaches. We see no justification for regulation to disturb that model, which generally makes sense.
Pillar III: transparent securitisations – Criterion 15 (<i>compliance with Prospectus Directive</i>)
We agree with this proposed criterion.
Pillar III: transparent securitisations – Criterion 16 (<i>compliance with Art 409 CRR re disclosure to investors</i>)
We agree with this proposed criterion.
Pillar III: transparent securitisations – Criterion 17 (<i>investor access to all underlying transaction documents to extent legally possible</i>)
We agree with this proposed criterion.
Pillar III: transparent securitisations – Criterion 18 (<i>clear provision in transaction documents for dealing with defaults, remedies, payment waterfalls and triggers for changes in waterfalls and reporting of trigger events</i>)
We agree with this proposed criterion.
Pillar III: transparent securitisations – Criterion 19 (<i>mandatory independent external verification of a sample of underlying assets to at least a 95% confidence level by a non-rating agency, confirmed in transaction docs</i>)
<p>This proposed criterion is not appropriate for CMBS, which addresses the related confidentiality concern differently. An alternative criterion (for example reflecting common best practice in the CMBS market) should apply for ABS where the underlying assets are non-granular.</p> <p>The proposed “95% confidence level” approach only works for securitisations with a granular pool, where an auditor can be engaged to review a statistically relevant sample of the pool and report on it on a basis that allows extrapolation across the entire pool. CMBS does not have granular pools, so a different approach is adopted. CMBS investors are typically provided with a much more detailed level of due diligence, including tenant, lease and property level information as well as information about borrowers and loans – either for every loan (where the number of loans is small) or for the largest loans (where there are a larger number of loans in the pool).</p>

Pillar III: transparent securitisations – Criterion 20 (*ready prospective and actual investor access to five year and/or stressed period historical performance data for substantially similar exposures*)

We disagree with this criterion insofar as it might relate to CMBS, for similar reasons to those discussed above. While the criterion may seem sensible in the context of consumer loans, it is neither workable nor useful in the context of a private, heterogeneous, cyclical and non-recourse asset class like CRE debt. Credit underwriting by prospective investors should focus on the loans and collateral before them. If there were significant demand among CMBS investors for historical data (for example, a few years' rental and cost or construction data for the actual collateral involved), the industry would no doubt respond. It is not for the EBA to impose such a requirement.

Pillar III: transparent securitisations – Criterion 21 (*ready prospective and actual investor access to data on individual underlying assets on a loan-by-loan level*)

We agree with this proposed criterion.

Pillar III: transparent securitisations – Criterion 22 (*detailed investor reporting at least quarterly*)

We agree with this proposed criterion, save that we would question whether pre-payment risk (referenced at the end of the rationale) can ever be modelled, even for granular portfolios, let alone a heterogeneous asset class like CMBS. It might be preferable to focus on a requirement for full disclosure of how a transaction deals with and allocates such a risk, than to impose more absolute and intrusive conditions that it may not be possible substantively to satisfy.

Question 6: Do you believe that, for the purposes of transparency, a specific timing of the disclosure of underlying transaction documentation should be required? Should this documentation be disclosed prior to issuance?

We have not received industry views on this question, other than to suggest that it might be reasonable to require underlying documentation to be made available on request (or through the listing authority), particularly where there is a limited number of known investors.

EBA-identified criteria addressing credit risk

We are surprised at the proposition that credit risk criteria should be used to exclude “extremely risky underlying exposures” from the simple standard and transparent securitisation framework.

The EBA seems to be focused on banks as investors in securitisation, forgetting the credit risk transfer benefits that securitisation (unlike covered bonds) can deliver. Against the backdrop of the full range of regulatory initiatives in this area, excluding riskier loans from the simple standard and transparent securitisation definition could lead to a serious adverse selection problem. Banks would be encouraged to encumber (via covered bonds) or sell (via securitisation) the best loans, and to retain the rest. Has the EBA considered how investors in bank equity, CoCo and senior unsecured bank debt might react to the riskier and more volatile bank balance sheets that might result? It is far from clear that the banking and financial system would be rendered more stable or resilient.

There is also an important real economy consideration here. Many activities and assets in the real economy are both risky and in need of finance, and investors should never be blinded either by risk or by returns in isolation: investment is all about risk-adjusted returns. If this framework is to consider credit risk at all, would it not be more natural to insist that “extremely risky underlying exposures” should **only** be financed through simple standard and transparent securitisation structures? That way, prospective investors would be given the best opportunity to assess the risk/return offered to them.

This comment is a general policy comment, not specifically made with CRE Debt or CMBS in mind.

Credit risk criteria – Criterion A (*origination in accordance with sound and prudent credit granting criteria, per specified provisions of EU Directives*)

We agree that sound and prudent credit granting criteria should be applied in originating underlying exposures – provided that is not used to exclude riskier loans.

Credit risk criteria – Criterion B (*max 1% exposure to any single obligor to ensure granularity*)

This proposed criterion may be appropriate in the context of homogeneous, granular consumer loans. It is entirely inappropriate in the context of CRE debt, however.

As explained above, in the context of this non-recourse market, the investor is not really taking credit risk on the sponsor/borrower. Rather, there is credit risk on the sponsor’s rent-paying tenants, and operational business risk on the sponsor’s skills as an asset manager (although even that will depend on some extent on the location, quality and nature of the real estate). While diversification at the tenant level will often be valuable, in other cases a single tenant (such as a government or quasi government institution) may be even better.

Credit risk criteria – Criterion C (*specific maximum eligible risk weights by reference to the standardised approach*)

As a matter of general principle, we do not agree with this proposed criterion. See our introductory comment above on section 5.4 (EBA-identified criteria addressing credit risk) of the DP.

It is also implicit in proposed criterion C ii) that only banks could originate simple standard and secure securitisations. It seems inappropriate to configure the rules in such a way as to make securitisation more difficult and expensive for non-bank originators.

Question 7: Do you agree that granularity is a relevant factor determining the credit risk of the underlying? Does the threshold value proposed under Criterion B pose an obstacle to the structuring of securitisation transactions in any specific asset class? Would another threshold value be more appropriate?

We disagree, as explained in earlier responses. Granularity is either not a relevant factor at all, or needs to be approached in a very different way, in the context of CRE debt and CMBS.

Question 8: Do you agree with the proposed criteria defining simple standard and transparent securitisation? Do you agree with the proposed credit criteria? Should any other criteria be considered?

Please see earlier responses. We agree with some of the proposed criteria defining simple standard and transparent securitisation, but believe others to be misconceived, at least in the context of CRE debt and CMBS. We disagree with the proposed inclusion of credit criteria.

Recommendation 4: Recommendation on the criteria defining ‘qualifying’ securitisations.

We strongly support a ‘qualifying’ securitisation label that incentivises best practice in the securitisation market. Eliminating unnecessary complexity, ensuring high levels of transparency and encouraging standardisation (on a basis that is sensitive to the particular characteristics of different ABS sub-sectors) are all good goals.

However, it would be very strange to create such a framework only to exclude exposures falling below a specified credit standard. That would discourage investor due diligence in relation to qualifying exposures (as credit vetting is part of the process for qualifying), and remove the incentive for simplicity and transparency that would facilitate investor due diligence for investments most deserving careful scrutiny.

We agree that capital requirements cannot ignore credit quality – but that is not a reason for excluding riskier exposures from the ‘qualifying’ securitisation framework. The correct approach would be to give better capital treatment to any particular securitised exposure that meets appropriate ‘simple standard and transparent’ criteria than the same exposure would attract if it did not meet those criteria. That would encourage simple standard and transparent securitisations without distorting capital flows to entire parts of the real economy (whether by reference to credit quality or by reference to particular sub-sectors).

The Executive Summary of the DP argues that “the capital treatment proposed for the ‘qualifying’ framework should aim at limiting the extent of non-neutrality of capital charges”. We disagree. The capital treatment of all securitisations should aim at limiting the extent of non-neutrality of capital charges – but securitisations that do not meet appropriately calibrated ‘simple standard and transparent’ criteria should suffer a capital penalty relative to those that do meet them.

Analysis on the capital treatment of qualifying securitisation positions

Recommendation 5: Recommendation on differentiated capital requirements treatment for 'qualifying' securitisation positions vs. other securitisation positions.

As mentioned above, we agree that 'qualifying' securitisations should enjoy privileged capital treatment, by applying a capital penalty to securitisations that fail to meet appropriately calibrated 'simple standard and transparent' criteria relative to the capital requirement had met those criteria. Those criteria must be sensitive to different asset classes in ways that the proposed criteria fail to be in certain respects for CMBS. It is important to 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.

As discussed above, we see far stronger policy grounds for excluding than for including credit criteria.

Question 9: Do you envisage any potential adverse market consequences of introducing a qualifying securitisation framework for regulatory purposes?

If the framework were introduced in the way we propose, we would not envisage adverse market consequences. If it is introduced as proposed, we would anticipate:

- No changes to underlying CRE lending practices, but less distribution of CRE exposures through securitisation and greater concentration of the associated risks among CRE originating firms
- Distortive incentives for traditional investors in CMBS to invest in less liquid, less transparent whole loans rather than in more liquid, more transparent CMBS
- Reduced transparency about the CRE debt market (including for regulators), which is private and relatively opaque save for that part of it that is securitised⁸
- Distortions in the flow of credit to particular parts of the economy, including the CRE sector that builds and maintains Europe's towns and cities, and many of the riskier assets and businesses that find themselves excluded by credit criteria
- Overall, failure to meet the intended policy objectives of this excellent initiative.

Recommendation 6: Principles on the implementation of a regulatory treatment for 'qualifying' securitisation positions.

We agree that the risk weights for qualifying positions should be lower, in relative terms, than the risk weights applicable to **equivalent** non-qualifying positions.

⁸ As you will be aware if you have followed the link included in footnote 3, Recommendation 1 in *A Vision for Real Estate Finance in the UK* puts forward a solution to the transparency problem (as it has for most of the other challenges to financial stability that CRE debt markets can present).

Question 10: How should capital requirements reflect the partition between qualifying and non-qualifying?

As explained in earlier responses, the important point is that neither credit considerations nor sub-sector characteristics should preclude 'qualifying' status. If that principle is respected, it would always be possible to apply a penalty to a non-qualifying exposure relative to an equivalent qualifying exposure, thereby incentivising simple standard and transparent securitisation without needlessly distorting capital flows with consequences for the real economy and financial stability that are difficult to predict.

Question 11: What is a reasonable calibration across tranches and credit quality steps for qualifying securitisations? Would re-allocating across tranches the overall capital applicable to a given transaction by reducing the requirement for the more junior tranche and increasing it for the more senior tranches other than the most senior tranche be a feasible solution?

We have not received industry views on this question.

Question 12: Considering that rating ceilings affect securitisations from certain countries, how should the calibration of capital requirements on qualifying and non-qualifying securitisations be undertaken, while also addressing this issue?

We have not received industry views on this question.