EU Review of the Macro-prudential Policy Framework: Proposed CREFC Europe submissions

Q1: Do you consider the degree of coordination between the different authorities in the current framework (i.e. ESRB, national macro-prudential authorities, Commission, Council, etc.) appropriate? [Please rank your answer from 1 (fully appropriate) to 5 (not appropriate at all), and explain your scoring.]

3 (neutral). We consider it important that the different relevant authorities are able to take a holistic and co-ordinated view across markets. Commercial Real Estate (CRE) is important at both the micro and macro levels and is affected by financial regulation across a variety of frameworks including banking, insurance and those affecting structured finance and alternative investment fund managers. Whilst CRE markets differ considerably at a national level in terms of structure and operation, those organisations delivering investment and debt in the CRE sector operate at an increasingly international level and there are significant transference effects in terms of financial stability, resulting both from this internationalisation and from arbitrage across national borders.

We note that there is a lack of consistency in how macro-prudential measures with a real estate sectoral focus are calibrated and activated at the national level and we consider that, whilst allowance must be made for national differences in structure and operation of CRE markets, a greater degree of co-ordination and related guidance would enhance macro effectiveness of such measures and prevent or reduce unintended consequences caused by non-level playing fields between jurisdictions.

We therefore consider it important that a degree of co-ordination between different authorities is at least maintained at the current level and there may be a case for increasing co-ordination in some areas, (in our responses to other questions, we mention some such areas, for example relating to data and sector expertise) whilst preserving the ability of national authorities to address responses to specific national characteristics of the CRE market.

Q2: (a) Would you consider appropriate to expand the macro-prudential framework beyond banking? [Please rank your answer from 1 (fully appropriate) to 5 (fully inappropriate), and explain your scoring.] (b) If deemed appropriate, what kind of systemic risks should be targeted and how?

1 (fully appropriate). Commercial Real Estate (CRE) is important at both the micro and macro levels and is affected by financial regulation across a variety of frameworks including banking, insurance and those affecting structured finance and alternative investment fund managers. There is a significant degree of interrelationship and transferability across these different sectors and we therefore consider, in relation to CRE specifically, that extension of the macro-prudential framework beyond banking is desirable in order to limit unintended consequences resulting from regulation of the banking sector whilst promoting healthy competition.

That is not at all to suggest that a "one size fits all" approach to regulation would be appropriate – it would not be. But it is difficult to see how macro-prudential oversight can be effective if it ignores large sections of a complex and diversifying financial system. We consider that some examples of systemic risks such as bank lending to non-banks, asset bubbles building up which would be likely to affect pensions and other personal investments via the fund management industry and direct asset price cycles would be relevant to address.

The primary goal should be information and monitoring. It would not be appropriate to impose inappropriately heavy regulation on newly diversifying CRE debt markets on a precautionary basis. Once appropriate information and evidence is available (in relation to the size and structure of the CRE debt market and, especially, the CRE cycle and the interaction of credit flows with it, incrementally counter-cyclical regulatory measures could be considered. We recommend you consider the proposals set out in the independent May 2014 UK real estate industry report, "A Vision for Real Estate Finance in the UK", available on the internet and from CREFC Europe.

Q3: Do you see a need to strengthen the coordination between designated and competent authorities when using stricter Pillar 1 measures for real estate exposures to address systemic risks? [Please rank your answer from 1 (strong need) to 5 (no need), and explain your scoring.] If you see a need, how should their coordination be strengthened?

1 (strong need). Subject to one important point, below, we strongly consider that there is a need to enhance co-ordination between designated and competent authorities when using stricter Pillar 1 measures for real estate exposures to address systemic risks. Macro research informs micro policy and micro instruments can be used to achieve macro policy results. This is particularly important in the case of measures affecting commercial real estate (CRE), which can have a strong pro cyclical tendency. One simple example relates to data relating to CRE lending exposures: while collection of such data may be very useful for the macro-prudential purposes of designated authorities, it would almost certainly be most naturally conducted by the competent authorities that interact with individual firms.

The important qualification is that we are concerned at the tendency (also apparent in this question) to refer to 'real estate' as if this meant something specific and readily identifiable. In fact, 'real estate' covers a very broad universe and the drivers and considerations – in economic, commercial and regulatory terms – are very different for some of the different parts of this universe. For example, residential mortgages are a consumer product affecting aspects of the housing market but also consumer spending. CRE debt, on the other hand, can unlock investment by specialist businesses that build, maintain and operate the physical premises other businesses need in order to operate. This question contains one of many generic references to 'real estate' in this Consultation Document, typically in the context of concerns about, or measures designed to mitigate risks arising from real estate lending exposures. It is important to resist the temptation to see 'real estate' as one homogenous asset class for which one particular regulatory approach is suitable. Even if one ignores other kinds of exposure and focuses solely on real estate lending exposures, these span:

- residential mortgages
- exposures to residential landlords large and small
- loans to support development, redevelopment, refurbishment, retrofit, or adaptation for the alternative use of buildings
- loans against income-producing real estate
- non-recourse loans where the credit analysis depends on the asset and its (tenant rental) cash flows, and loans with full recourse to the sponsor
- loans that are very low risk, and loans that are very high risk
- loans made by different types of lender, which may be intermediated or not, retained or distributed, in loan or bond format, alone or with other loans, with risk tranching or without.

The delineations are not hard-edged and there is frequently challenge and debate around how the line should be drawn in particular areas. Importantly, a great deal of important lending activity is closely related to real estate while having quite specific characteristics – for example, lending to households supported by one or two small-scale rental properties that supplement their income, or lending to small or medium-sized enterprises secured on premises they occupy for the purposes of their business. Our expertise relates to CRE debt (itself a broad and varied subset of 'real estate', and our response relates solely to that.

Coordination should be strengthened in the light of our earlier comments, and following suitable consultation with industry experts.

Q4: Do activity-based instruments in the current framework allow to effectively tackle risks stemming from specific risk exposures? [Please rank your answer from 1 (fully agree) to 5 (fully disagree), and explain your scoring.]

4 (disagree). We consider there is some confusion regarding the operation and intended use of the SRB – this is addressed elsewhere in this Consultation. We also believe there may be a case for the introduction of additional measures operable on a national basis such as sectoral exposure limits.

With regard to existing activity-based instruments, we consider their current effectiveness in relation to the commercial real estate (CRE) sector is likely to be severely limited by the lack of available accurate and high quality data. We also consider the extension of the current regulatory framework to cover non-bank lending and lending by banks to the fund/asset management and pension sectors in the CRE space an important addition to the macro prudential framework. CRE investment (including in the form of debt) plays an important role as an enabling force in the real economy, perhaps most obviously by providing the premises that businesses need in order to operate. Effective regulation (including through the use of activity-based instruments) requires an understanding of these benefits as well as of the potential risks.

We have some concern that in order to make the most effective use of activity based instruments in the CRE sector, a sophisticated level of sector knowledge is required and this may not currently be available internally or indeed accessible externally in the case of many regulatory bodies. We believe that increased access to this specific expertise would significantly enhance the effective operation of the existing instruments and limit unintended consequences .It may be that there is a case for a supra national pool of expertise in this respect which would be available to advise and guide across the regulatory framework.

Q5: Do you consider a CCB for sectoral imbalances (e.g. in the real estate sector) a useful complementary instrument? [Please rank your answer from 1 (necessary complement) to 5 (useless complement), and explain your scoring.] If yes, how would you see the interaction of this sectoral CCB with the CCB already in place?

3 (neutral). We consider a CCB for sectoral imbalances in the commercial real estate (CRE) sector potentially useful. However there are complexities in operation and challenges around how to measure the stage in the cycle. In this respect we believe the recommendations set out in the 2014 report 'A Vision for Real Estate Finance in the UK' are especially relevant. From the point of view of international banks, they would need to continually monitor many jurisdictions and as the final requirement at a consolidated level is calculated as a weighted average, it may prove ineffective in tackling national macro prudential goals. It is easier to see clarity of operation and effectiveness for mono national organisations. We suggest that additional suitable tools (such as those mentioned in our response to Q9 & Q17) available for operation at a national level may be useful in complementing this.

Q6: Do you see a need for adjusting measures targeting risks associated with banks' real estate exposures? If so, please explain your answer.

Yes. There is a troubling tendency (apparent in this Consultation Document) to refer to 'real estate' as if this meant something specific and readily identifiable. In fact, 'real estate' covers a very broad universe and the drivers and considerations – in economic, commercial and regulatory terms – are very different for some of the different parts of this universe. For example, residential mortgages are a consumer product affecting aspects of the housing market but also consumer spending. CRE debt, on the other hand, can unlock investment by specialist businesses that build, maintain and operate the physical premises other businesses need in order to operate. The Consultation Document contains many generic references to ‘real estate’, typically in the context of concerns about, or measures designed to mitigate risks arising from real estate lending exposures. It is important to resist the temptation to see ‘real estate’ as one homogenous asset class for which one particular regulatory approach is suitable. Even if one ignores other kinds of exposure and focuses solely on real estate lending exposures, these span:

- residential mortgages
- exposures to residential landlords large and small
- loans to support development, redevelopment, refurbishment, retrofit, or adaptation for the alternative use of buildings
- loans against income-producing real estate
- non-recourse loans where the credit analysis depends on the asset and its (tenant rental) cash flows, and loans with full recourse to the sponsor
- loans that are very low risk, and loans that are very high risk
- loans made by different types of lender, which may be intermediated or not, retained or distributed, in loan or bond format, alone or with other loans, with risk tranching or without.

The delineations are not hard-edged and there is frequently challenge and debate around how the line should be drawn in particular areas. Importantly, a great deal of important lending activity is closely related to real estate while having quite specific characteristics – for example, lending to households supported by one or two small-scale rental properties that supplement their income, or lending to small or medium-sized enterprises secured on premises they occupy for the purposes of their business.

Whilst we appreciate that this Consultation Document is not aimed specifically at real estate, we are concerned that the lack of more specific delineations may lead to similarly generic responses from non-specialists, and confusion in the interpretation of responses. The real estate universe is very broad, as well as being very important in terms of both financial stability and the economy. Information, expertise and differentiation is needed for any measures targeting elements of it to be appropriate, effective and proportionate.

Helpfully, the 2014 report ‘A Vision for Real Estate Finance in the UK’ made seven recommendations aimed at reducing the risks that feedback loops between CRE and credit can pose, principally to financial stability but also to the real economy. While its focus was the UK, most of its recommendations have broader application in the European context. Recommendations cover:

- improving data collection, quality, availability and analysis
- improving training and expertise
- recognising that vintage and the CRE cycle are key risk factors and ensuring that regulatory capital requirements are designed to address that and do not promote pro-cyclicality
- promoting diversity and variety in the supply of debt (i.e. reducing reliance on the banking market by positively encouraging alternatives as well as by constraining inappropriate risk-taking by banks)

- ensuring that regulation is as far as possible predictable in its application (by being automated), incremental and counter-cyclical.

Q9: Do you see the need to better frame either the focus (targeted risks) or the scope of the SRB (i.e. applicability to the entire stock only or also to subsets of exposures)? If so, please explain your answer.

Yes. We consider that there may be a case for use of the SRB on a sub-set basis (in particular aimed at targeting asset bubbles in specific sub-sectors such as residential property or commercial real estate (CRE)). However, it would need to be clear and consistent in application so as to send appropriate messages and to avoid having an adverse effect on institutions' ability to plan their business.

Q10: Should the SRB be explicitly defined as either an activity based or an institution specific tool? Please explain your answer.

Yes. We consider there is a strong case for defining the SRB as an activity-based tool. This would enable clarity in its use for targeting specific asset bubbles and would distinguish it from the SII buffers which capture institution specific matters.

Q17: Do you see a need for developing additional harmonized macro-prudential instruments? If yes, what type of new instrument would you deem necessary and why?

Yes. We consider that there may be a good case for developing additional harmonised macro prudential instruments such as the right for designated authorities to impose overall exposure limits applicable to banks' exposures to the CRE sector. However, we have a reservation about the current availability and fitness for purpose of appropriate data to enable the operation of such instruments. The flow of credit to the CRE sector supports a great deal of valuable construction activity and long-term investment in the real economy, so constraining that flow in the interests of managing macro-prudential risks is not cost-free. We also believe it is important that designated authorities considering the use of such instruments should have access, (either internally or externally) to the relevant expertise to ensure appropriate application of such measures. Again, the recommendations of the 'Vision' report are highly relevant in this context, not only for the UK, but (in many cases even more starkly) for other European jurisdictions.

Q18: How do you assess the possibility for the ESRB to develop technical guidance on the use of non-harmonised instruments, for example via issuing recommendations? Would you see a specific type of instrument for which such an approach could be warranted and suitable?

We consider that in order to develop and issue meaningful technical guidance on commercial real estate (CRE) sector-specific non-harmonised instruments, a sophisticated level of sector knowledge together with a strong understanding of the structure and operation of the CRE market in the various jurisdictions is required and this may not currently be available internally or indeed accessible externally. We believe that increased access to this specific expertise would be key to ensuring that any guidance developed is relevant, appropriate and without unintended consequences. It may be that there is a case for a supra national pool of expertise in this respect which would be available to advise and guide across the regulatory framework.

Q30: How do you assess the current capacities of the ESRB to deliver on its mandate for conducting system-wide risk analysis, including its access to relevant data? [Please rank your answer from 1 (fully adequate) to 5 (not adequate), and explain your scoring.]

4 (not really adequate). As already mentioned in our responses to earlier questions, commercial real estate (CRE) and CRE debt are highly important at micro and macro levels and across a variety of

regulatory frameworks covering different sectors of the financial markets. The CRE sector is also a critical, enabling element of the real economy, supporting construction and maintenance of commercial buildings that are fit for purpose, and channelling savings into long-term, income-producing investment.

We therefore consider that the ESRB has a very important role to play – but also a difficult one, depending as it does on access to appropriate and good quality CRE data and to the appropriate CRE-related regulatory expertise. We strongly doubt whether the quality and availability of current CRE debt-related data is sufficient to enable the ESRB to deliver as effectively as it might on this element of its mandate. We also note that it is frequently challenging for regulators to maintain the appropriate level of internal expertise ideally required to fully engage with and understand the CRE markets and we would encourage the ESRB to ensure that, if it does not maintain this depth of specialist expertise internally, it has the appropriate forum to draw on relevant external specialist expertise.

Q31: In particular, do you consider that the resources of the ESRB Secretariat are adequate in this context? [Please rank your answer from 1 (fully adequate) to 5 (not adequate), and explain your scoring.]

4 (not really adequate). As already mentioned in our responses to earlier questions, commercial real estate (CRE) and CRE debt are highly important at micro and macro levels and across a variety of regulatory frameworks covering different sectors of the financial markets. The CRE sector is also a critical, enabling element of the real economy, supporting construction and maintenance of commercial buildings that are fit for purpose, and channelling savings into long-term, income-producing investment.

We therefore consider that the ESRB has a very important role to play – but also a difficult one, depending as it does on access to appropriate and good quality CRE data and to the appropriate CRE-related regulatory expertise. We strongly doubt whether the quality and availability of current CRE debt-related data is sufficient to enable the ESRB to deliver as effectively as it might on this element of its mandate. We also note that it is frequently challenging for regulators to maintain the appropriate level of internal expertise ideally required to fully engage with and understand the CRE markets and we would encourage the ESRB to ensure that, if it does not maintain this depth of specialist expertise internally, it has the appropriate forum to draw on relevant external specialist expertise.