Response to the BCBS Consultative Document *Standards: Revisions to the Standardised Approach for credit risk* (issued for comment by 27 March 2015)

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. Our core membership includes commercial as well as investment banks, as well as other 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 not only with banks, but also with non-originating investors, borrowers and regulators in promoting CRE debt markets that support the real economy without compromising financial stability.

Introduction

We believe that an important part of Europe's CRE debt market will continue to be played by banks, including many of the smaller, regional or national banks more likely to use the standardised approach. We also note the proposals for capital floors based on standardised approaches, which would extend the relevance of the standardised approach beyond banks that actually use it. The proposals in the CD are therefore important and relevant to the industry we represent.

This submission focuses solely on the proposals and questions specifically relating to real estate exposures, our area of expertise.

General comments

The CRE industry is a very important part of the real economy[1] and the way it is financed has a longstanding (and not always happy) relationship with financial stability. A sustainable flow of credit to that industry is vital if it is to serve the economy effectively and provide the returns that cause investors to fund the built environment of our towns and cities. Debt is often critical for making some of the most socially and economically important CRE investments viable. Equity funding alone is too expensive or too scarce for smaller-scale CRE investment outside gateway cities, for construction/development projects, and for urban regeneration schemes, often involving or unlocking significant investment in social and urban infrastructure. It is often only the local branch networks of smaller regional or national banks that provide the debt required for such investment.

However, it is quite true that poor lending decisions are a cyclical problem for banks, which will habitually lend over-exuberantly as the peak of the cycle approaches. Regulators, too, have a poor track record of mitigating that problem through appropriately counter-cyclical regulatory rules. A May 2014 report, *A Vision for Real Estate Finance in the UK*, published by an independent UK CRE industry group called the Real Estate Finance Group analyses the problems of feedback loops between the CRE cycle, the credit cycle and the regulatory cycle, and makes recommendations for how they might be addressed in a coherent, strategic and holistic way.[2] We hope that you, and other regulators, will value and benefit from this unusual pro-active effort from the business world to address past failings through solutions developed with the benefit of a deep knowledge of the relevant industry sector.

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[1] See for example the 2014 industry report produced by the European Association for Investors in Non-Listed Real Estate Vehicles (**INREV**) and the European Public Real Estate Association (**EPRA**) available here https://www.inrev.org/news/31-publications/public-affairs/742-real-estate-in-the-real-economy.

[2] The report is available at: http://www.ipf.org.uk/industry-involvement/a-vision-for-real-estate-finance-in-the-uk.html. While its focus is the UK CRE lending market (rather than a more global perspective), there is much in it that can help foster a sustainable (CRE debt) securitisation market.

Specific comments and responses to questions in the CD

We have the following specific observations and comments in response to the CD.

(a) As a general matter, we believe the standardised approach should recognise **the value of collateral** that provides security for a loan. This is relevant in the general context of lending to smaller businesses, which is often made possible, or made easier, by the availability of security over physical assets such as commercial premises. The point is also relevant to the discussion of the net NPA ratio (**Question 2**), and the discussion of risk drivers generally for corporate exposures (**Question 5**), and specifically in relation to SME lending (**Question 6**).

We accept that in very specific circumstances (such as where the security is not enforceable or the property has not been valued appropriately – Section 2.5), it may be appropriate to disregard security.

(b) We believe that the proposals in relation to specialised lending (**Section 2.2.2 and Question 8**) should be reconsidered. The capital charges proposed would, in effect, be penal on a relative basis and that would discourage the financing of important parts of the real economy, including infrastructure and CRE. That is particularly the case because special purpose entities are usually used to carry on such activities, so it is the higher charges that would apply. That would create real problems for the flow of investment capital generally to these important, enabling parts of the economy which can attract long-term investment while supporting growth – high policy priorities in many countries (and for the European Union).

We are especially concerned at the proposed imposition of even higher charges on development and construction finance within an inflexible framework such as is proposed. That would surely have a particularly harmful social and economic impact because development and construction projects are by their nature high risk, and require equity (which is higher risk and therefore higher cost for the developer/borrower) to be paired with debt (which is lower risk for the lender and therefore lower cost for the developer/borrower) to make economic sense for private sector developers.

The implications of these proposals would presumably affect all banks, rather than only those using the standardised approach, if the proposals relating to capital floors based on the standardised approach are taken forward. The result would be a reduced flow of bank credit to these important parts of the real economy, reducing overall investment save to the extent that alternative (and probably more opaque and more lightly-regulated) debt providers step into the gap left by banks.

It is very difficult to see why it would be a policy objective to reduce the availability and increase the cost of bank finance for specialised lending exposures in the way proposed. Infrastructure, income producing real estate (**IPRE**) and development and construction are all critical investment activities from a socio-economic perspective. Without them, our cities, economy and society would be unrecognisable. It is likely that the public sector would have to take the investment risk that private sector businesses, deprived of adequate and sensibly priced debt, would no longer accept.

(c) We would also like to comment on the way IPRE, as a specialised lending exposure, is risk-weighted under the existing IRBA slotting regime which would presumably form the basis for risk-weighting here as well. A few months ago, we produced (for the European Banking Authority) a **commentary on the IPRE slotting criteria** currently in place in the UK. They identify a number of inconsistencies and challenges that we believe the Committee might wish to consider, particularly if the use of that approach is to be extended. That commentary is attached as an **appendix** to this submission.

Perhaps the single most important point to make in that context is that we do not think it is safe or appropriate to rely on LTV as a risk measure if V is market value. As discussed extensively in *A Vision for Real Estate Finance in the UK* (referenced in footnote 2 – see in particular Recommendation 4), market value based LTV is a poor indicator of risk. We would strongly recommend developing a more stable, cycle-insensitive concept of value: that, combined with a normal market valuation, would help a lender (and its capital regime) better assess cycle risk, which is what really matters in the IPRE context.

(d) **Section 2.5.1** raises – but does not answer – an important question as regards **the distinction between "commercial" and "residential" real estate**. In many countries, functionally residential property may be held as an investment and rented out to an occupier who is not its owner. This is an activity that can be carried out on anything ranging from a very small scale and fairly amateur basis, to a very large scale and professional basis. Many large-scale institutional and corporate residential landlord businesses will also carry on an investment business in relation to functionally commercial real estate. The market commonly regards the term "commercial real estate" as including commercial investment in functionally residential real estate.

There are many important differences between lending to an individual renting out one or two apartments, and lending to a large listed property company, private estate or insurance firm that owns and operates hundreds or thousands of rental homes on a commercial basis. Is it right to classify the real estate in both cases as "residential"? Or are there cases in which it is appropriate for a "commercial" approach to the real estate business to override the functionally "residential" nature of the underlying real estate? This matters a great deal if quite different risk weights are applied to loans secured by real estate depending on whether it is "residential" or "commercial".

We suspect that classification is unlikely to be consistent across different banks in different countries. We would encourage the Committee to recognise this question and consult on possible approaches.

(e) In relation to **Questions 10, 11 and 12**, while we are not experts on residential real estate, we would draw your attention to our comments on LTV at 2 above and on LTV, DSC and other matters in the separate **appendix**.

(f) **Section 2.5.2** discussed exposures secured by CRE. As we understand it, this is intended to cover lending that would not fall within the IPRE limb. We are not sure precisely what this section is seeking to describe, but have the following comments.

The Committee has identified three conditions (set out in section 2.5) that must be satisfied for a loan secured on CRE to qualify as IPRE lending. As we understand it, if any of those conditions is failed in the case of a non-retail borrower, section 2.5.2 would seem to be in point. The three conditions seem a strange and disparate collection.

- We have no comment on the first condition (uncompleted property) in the residential context described; however, we would disagree with the proposition that the fact that a commercial building is not fully completed should prevent IPRE treatment from applying. We assume that is not what the Committee is suggesting.

- Where the second condition (security unenforceable) is failed, it is difficult to see why any value should be attached to the collateral, so in this case, our response to **Question 14** would be that option A would seem the natural answer.

- Where the third condition (no proper valuation) is failed, it would seem very odd to adopt option B, which relies on LTV and therefore on value. So (subject to the following comment) our response to **Question 14** in this case too would be that option A should be preferred.

- As regards **Question 15**, one approach might be to allow the use of option B provided that the security is enforceable and an appropriate external valuation has been obtained.

Having said all that, we recognise that there is a real question regarding the treatment of CRE collateral which is owner-occupied, or where the tenant is closely connected to the owner – in other words, where there is CRE security but the basic requirements for qualifying as a specialised lending exposure are not satisfied. We understand that this kind of arrangement is common in SME lending, where the lender is primarily relying on the business performance of the borrower, but obtaining additional comfort from the value of the collateral. It would seem important to ensure that the approach to risk weighting in this context does not create distortions as compared to IPRE. Subject to the comments made above, in the appendix and in A Vision for Real Estate Finance in the UK about the use of LTV, we would probably prefer option B, which at least recognises the value of the collateral.

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

Yours faithfully

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Enc.: Appendix containing Commentary on UK PIPRU slotting criteria