

Response to the EBA's Consultation Paper dated 11 May 2015 (EBA/CP/2015/09): Draft Regulatory Technical Standards on Assigning Risk Weights to Specialised Lending Exposures under Article 153(9) of Regulation (EU) No. 575/2013 (CRR)

Introduction

CREFC Europe is a trade association promoting a diversified, sustainable and successful commercial real estate debt market in Europe. Our core membership includes commercial banks, investment banks, real estate debt funds, other lenders and intermediaries who help connect capital seeking the risk and returns of real estate debt with real estate firms seeking finance. Among our other activities as an industry association, we seek constructive and effective dialogue not only with the community from which our membership is drawn, but also with non-originating investors in real estate debt, borrowers and regulators. We believe we all have a shared interest in promoting real estate debt markets that are transparent, diverse and liquid, supporting the real economy without compromising financial stability. We are listed on the EU Transparency Register with ID number 050415314994-69.

We are grateful for the opportunity to comment on the EBA's draft RTS on assigning risk weights to specialised lending exposures (**SLEs**). SLEs relate to a range of key 'real economy' activities, including infrastructure and commercial real estate construction and investment. It is as important to maintain a sustainable and responsible flow of credit to these sectors as it is to ensure that the risks these exposures pose to firms (and potentially even to financial stability) are appropriately understood and managed. Our interest and expertise relates specifically to SLEs involving income-producing real estate (**IPRE**), so it is from that perspective that we provide our comments.

Our complete comments and recommendations are set out below. We have highlighted our responses to specific questions from the consultation paper.

Supervisory slotting as an approach for IPRE exposures

As an approach, supervisory slotting favours simplicity and safety over sensitivity. While there is much to be said for such an approach, supervisory slotting was never subjected to the level of scrutiny that it should have had. When Basel II was introduced, the general expectation and intention was that supervisory slotting was unlikely to be used by many firms, or that it would be used only temporarily on the road to approval of internal ratings based (**IRB**) models for SLEs. It has, however, attracted considerable attention since the UK regulator mandated its use in relation to the IPRE exposures of all UK regulated firms using an IRB approach. The picture that emerges is a mixed one.

To begin with, we believe there are real grounds for concern in two areas.

- (1) **The competitive distortion concern:** Significant competitive distortions can arise in the market as a result of the very great differences in regulatory capital requirements between banks using A-IRB or F-IRB, and banks using slotting (especially at the 'strong'/'good' end of the spectrum). The risk weighted assets (**RWA**) relating to an IPRE exposure with strong characteristics can be several times higher under slotting compared to what an A-IRB model might produce.

The proposed solution: If the EBA is keen to improve consistency of approaches for determining RWAs for SLEs across the EU, it might explore how the Basel framework might be adapted so as to reduce the differences in RWA outcomes under slotting and under IRB models (especially at the lower risk end of the spectrum). That might be achieved by the introduction of one or two additional, lower risk weight, categories within the slotting framework.

- (2) **The pro-cyclicality concern:** Basel-derived criteria for assigning risk weights are (at least in relation to IPRE exposures) vulnerable to having strongly pro-cyclical effects. We have previously provided you with a commentary of the (very similar) criteria currently in place in the UK where these pro-cyclical effects are highlighted and potential corrections are suggested. We would be happy to elaborate further if that would be helpful.

The proposed solution: Given that by far the most reliable indicator of risk in IPRE lending is the point in the cycle at which a loan is written, regulatory capital rules should be designed to operate in a counter-cyclical way.

However, we recognise the value of simplicity and safety and we are sympathetic to regulators' desire to discourage excessive complexity after the financial crisis. We highlight two points in this connection.

- (1) **The importance of data.** It is genuinely difficult for firms to build effective IRB models for exposures to heterogeneous asset classes such as IPRE, given the limited amount of data available to them. The lack of reliable and comparable data about IPRE debt markets is more generally problematic. The IPRE loan market is a private market, so data are only generally available for those IPRE loans that are securitised and sold in the form of rated bonds (commercial mortgage backed securities or CMBS) to investors. Unfortunately, the CMBS market in Europe is small and shrinking, not least as a result of post-crisis regulatory changes. As a result, it is very difficult for market participants, investors and regulators to access the information required to participate, invest in or regulate this market appropriately.

The EBA and national regulators should consider how they might promote the creation of a database of IPRE loan-level information with controlled public access to anonymised data, so that this opaque but economically and systemically significant market might be better understood.

- (2) **The resilience-enhancing role of structural diversity in the lending market.** The introduction of slotting for UK regulated firms helped to open up space for other lenders to enter the market. That is potentially a good thing, because IPRE lending risk in the UK (and indeed in Europe) has traditionally been highly concentrated within the banking system. If new lenders bring greater diversity of strategy and product type, and lower correlation in lender responses to market signals, financial system resilience and stability would also be enhanced.

We would encourage the EBA, as well as national regulators, to consider how they might promote the structural diversity of IPRE lending markets so as to enhance financial system resilience.

Those two suggestions (for a loan database and for the encouragement of structural diversity) were among seven recommendations for reducing the vulnerability of the UK's banking and financial system to the commercial real estate cycle in a report published in May 2014 by an independent industry group, the Real Estate Finance Group. The report also highlights the need for a counter-cyclical approach to information and regulation, including through the way LTV is used. The report, *A Vision for Real Estate Finance in the UK*, is available [here](#). We would encourage you to read it, as its analysis and recommendations are relevant beyond the UK, both in relation to slotting and more generally.

Q1: *What are the operational challenges of using the slotting approach? Is it possible to obtain comparable capital requirements across institutions using the slotting approach? Should the slotting approach in your view be extended to other types of exposures, and if yes, for which types of exposures would this be particularly useful?*

Operational challenges: We are most familiar with the introduction of slotting for all UK regulated firms' IPRE exposures. At a strictly operational level we understand that firms have generally adjusted their systems and methodologies to the requirements of this new regime. However, the limited number of risk weight categories under slotting means that there is in many cases a significant mismatch between true

economic risk and regulatory capital outcomes. A related consequence is that the competitive position of UK firms subject to slotting is compromised – especially for exposures at the ‘strong’/‘good’ end of the spectrum – relative to the UK branches of overseas banks using F-IRB or A-IRB. These distortions are more problematic and deserving of the EBA’s attention than any differences in the way different firms apply the slotting criteria to assign risk weights to SLEs.

Comparable capital requirements across institutions using slotting: We have highlighted the clear lack of comparability of capital requirements between firms using slotting and those using other approaches. Another problem is the lack of consistent and comparable SLE data, which makes it difficult to judge whether there are material differences across firms or EU member states in the way slotting is operated. Again, this strikes us as a more important focus for the EBA than mechanistic harmonisation in the way firms using slotting assign risk weights.

Indeed, given the intrinsically non-granular nature of SLEs, reliable comparison of exposures (and thus of the capital requirements relating to them) is inevitably difficult. An overly mechanistic methodology for assigning risk weights would not alter that fundamental fact, but could have the undesirable effect of further reducing the risk sensitivity of the slotting approach, creating distortions and arbitrage risk.

Extending slotting to other types of exposures: While we see the case for increasing the emphasis on simplicity and clarity, as explained above we have significant reservations about slotting as an approach, partly because it was not subjected to rigorous scrutiny when it was designed as no-one expected it to be used widely, or other than temporarily. Generally, therefore, we would recommend reviewing and improving slotting (in particular to remove its pro-cyclical features in the IPRE context) before contemplating any extension of its use to other types of exposure. Subject to those comments, the strongest candidate for an extension of slotting would be to appropriate types of exposures currently subject to the standardised approach, where it might increase, rather than reduce, the risk sensitivity of regulatory capital.

The criteria for assigning risk weights to IPRE exposures

As mentioned above, we have concerns that the Basel-derived criteria for assigning risk-weights to IPRE exposures are not well designed. They focus excessively on idiosyncratic risk and insufficiently on market, cycle and refinancing risk, which are the strongest determinants of losses. As a result, the criteria are unhelpfully pro-cyclical, requiring institutions to set aside more capital at the wrong time: not as the cycle approaches its peak, but after it suffers a correction. We refer you to past submissions¹ and to [A Vision for Real Estate Finance in the UK](#) on this subject, and would be happy to discuss further if that would be helpful.

Having said that, for banks that have invested considerable resources to implement slotting based on those criteria over the last few years, there is plainly something to be said for continuity and consistency. While we would encourage the EBA (and indeed the BCBS) to consider updating and improving the criteria in consultative collaboration with industry, we do not object to the EBA’s decision to avoid diverging radically from the Basel text at this stage.

Two relatively narrow areas where changes might nevertheless be considered at this stage are:

- (1) in relation to loans against properties under construction (where the existing criteria do not, in our view, make appropriate provision); and

¹ Email correspondence with the EBA in November 2015.

- (2) to distinguish appropriately between loans against single tenant and multi-tenanted properties (where the different considerations that apply are not adequately recognised by the criteria).

We have explored these areas in previous submissions and would be happy to discuss further with you.

The methodology for assigning risk weights to IPRE exposures

We do not agree that there is a need to impose prescriptive methodologies for translating consideration of the factors (and sub-factors) into a specific risk weight. Slotting is a highly prescriptive approach as it is. Appropriately weighting the different factors (and indeed sub-factors) for each IPRE exposure is one area where a certain degree of flexibility remains, and we believe maintaining that flexibility is important. IPRE is heterogeneous and the weight of each sub-factor can differ dramatically from one exposure to another for good reasons.² Institutions should be encouraged to use reasoned and documented judgment rather than having a mechanistic approach imposed on them.

The EBA has not produced any compelling evidence to suggest that the methodologies currently in use are giving rise to problems – whether relative (inconsistency across firms or EU member states) or absolute (inappropriate assignment of risk weights). We do not believe that any conclusions can safely be drawn from the fact that SLEs are differently distributed across the risk weight categories in different EU member states.

- Only in the UK and Spain is the sample size substantial, and slotting was only imposed on UK institutions in 2011-12, so the available data relate only to a specific, narrow time period.
- More importantly, the real estate market differs greatly between EU member states, and the mix of legacy and new loans differs greatly between institutions but also between EU member states. In the UK, for example, the institutions have largely sold or resolved their legacy IPRE exposures and may be disinclined, as a policy matter, to make new IPRE loans that would not qualify as “strong” or “good” in the current, relatively strong, market environment. The state of the market and of bank balance sheets (including as regards the legacy of exposures originated before the crisis) is very different in different EU member states.

Furthermore, we doubt that the implementation of either Option 1 or Option 2 would result in a significantly different distribution of exposures across the categories in particular institutions, so we do not think the cost and disruption of imposing a change in methodology can be justified on those grounds.

If the EBA’s concern is principally about a lack of harmonisation between EU member states, we would suggest the best option would be to start with how institutions assign risk weights in the UK, for the simple reason that the UK accounts for well over half of all EU SLEs subject to slotting (and there has been no suggestion that the methodologies in use in the UK are problematic). The methodologies used in other EU member states could then be considered and compared to those in the UK and any material divergences assessed to determine whether they can be justified or should be brought into line with the UK. It is not clear whether the EBA has undertaken any such exercise.

² For example, the financial strength of the sponsor may be very important if the collateral is supported by a guarantee or other recourse to the sponsor (uncommon other than for small ticket IPRE loans); or the sponsor’s expertise and asset management skills (but not its financial strength) may be very important in the context of a non-recourse loan secured on an asset in a secondary location; both may be important for a construction loan supported by recourse to the sponsor; and neither will be at all important for a non-recourse loan secured on a good quality new building in a prime location.

Q2: *What would be the preferred approach for the combination of the factors into a final assignment to a category? What are the advantages and drawback of either approach? Are both options equally clear or should further guidance be provided? Are there other approaches that could be used to harmonise how the different factors are combined into a final assignment for the risk weight?*

As explained above, we do not believe that there is a need to harmonise how the factors are combined into a final assignment for the risk weight. Both of the options proposed are too mechanistic and implementing either of them would entail material costs without delivering material benefits. It seems particularly unjustifiable to impose a new, prescriptive methodology on the UK institutions whose use of slotting accounts for well over half of all SLEs subject to slotting in the EU. No case has been made to suggest that the methodologies used in the UK are in any way inappropriate, so if it is felt necessary to harmonise across EU member states, the UK's approach might serve as the most natural starting point.

If the EBA is nevertheless determined to choose either Option 1 or Option 2, our preference would be for Option 2 because it is more sensitive and better able to accommodate the diversity of IPRE than Option 1. Option 2 should be improved by removing (or at least substantially reducing) the proposed [10]% minimum weighting for any factor. Attaching no weight to a particular factor in a particular case would not be inconsistent with the requirement that all factors be considered. Indeed, we would argue that the Basel framework requires that if (for example) a factor is found, after appropriate consideration, to be irrelevant in a particular case, it should be treated as such and given a zero weighting.

The EBA makes a specific and somewhat controversial proposal regarding the determination of the remaining maturity of SLEs. It argues that the remaining maturity should be the higher of the contractual remaining maturity and the expected remaining maturity of the exposure, on the grounds that the remaining maturity of an exposure is not necessarily as set out in the contractual provisions but can be altered subsequently. This proposal seems to us to be outside the scope of the EBA's mandate, and its rationale seems, from the IPRE perspective, unconvincing. We would recommend using solely the contractual maturity, consistent with the A-IRB and Standardised Approaches and also with the guidance set out in the Basel text itself.

Q3: *Do you agree with the classification of specialised lending and the descriptions given?*

Yes.

Q4: *Do you agree with these documentation requirements for each specialised lending exposure for which risk weights are assigned according to this Regulation?*

Yes.

Q5: *Do you have any suggestions or comments on the assessment criteria for project finance?*

No.

Q6: *Do you have any suggestions or comments on the assessment criteria for real estate?*

We agree that applying a single set of criteria across the EU would promote consistency and harmonisation. The proposed criteria have the virtue of closely following Basel and therefore being very similar to those already in use in the UK, for example. We do however believe that the criteria for real estate (IPRE) would benefit from a fundamental review designed to remove double-counting and arbitrary elements and replace their structural pro-cyclicality with structural counter-cyclicality. We refer you to our more general comments above and our past submissions to you on this subject, as well as to the comprehensive analysis of real estate finance markets, risk and regulation in the May 2014 report, [A Vision for Real Estate Finance in the UK](#).

Q7: Do you have any suggestions or comments on the assessment criteria for object finance?

No.

Q8: Do you have any suggestions or comments on the assessment criteria for commodities finance?

No.

Q9: Do you have any suggestions or comments on the Impact Assessment?

We believe that the stated objectives of the RTS (para 5.1.3) over-emphasise harmonisation within slotting and under-emphasise both (i) the comparative position across SLEs (slotted and not), and (ii) the bigger question of mitigating systemic risk associated with SLEs (notably, in the case of IPRE, by building counter-cyclicality into the criteria or the way they are used).

Given that more than three quarters of exposures subject to slotting are in two countries (the UK and Spain), and given the enormous differences between market conditions and the nature and condition of the banking systems in different EU member states, it is not at all clear on what basis the EBA has concluded that a mechanistic approach to how risk weights are assigned (i.e. not merely in terms of the criteria themselves) is required to promote harmonisation. The alleged need for harmonisation in terms of permitted methodologies for assigning risk weights cannot be fairly assessed without more information than the EBA has provided (for example, a comparison similar to that in Tables 1 and 2 in relation to the SLE lending under F-IRB and A-IRB alongside SLE lending under slotting).

Based on the analysis and data provided by the EBA in Table 5 and elsewhere in this consultation paper, we do not agree that “it is reasonable to conclude that harmonising the combination of the different factors would to a certain extent contribute to a greater consistency of capital requirements at a minimum cost”, nor that “it is therefore the most cost-effective approach”. Those are unsubstantiated assertions, because the costs for affected institutions have not been considered, and the benefits (of solving a problem whose existence has not even been established) have not been quantified.

We are at your disposal if you would like to discuss any of the above further, or more generally to explore how IPRE exposures can be more effectively managed by regulatory capital rules (under supervisory slotting or otherwise).

Yours faithfully

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