Submissions of CREFC Europe in response to the European Commission's Call for Evidence on the EU Regulatory Framework for Financial Services

Executive summary
The absence of references to commercial real estate (**CRE**) in the European Commission's CMU proposals is striking, because the functional characteristics of CRE are so closely connected with key elements of CMU. The provision to ordinary businesses of premises to rent is a "critical infrastructure" quasi-financial service, especially for new and growing businesses – a central concern of CMU. A sophisticated and professional CRE market allows capital, time and expertise to be used far more efficiently in the economy than would be possible if every business had to buy or build its own premises, or try to find space that was surplus to someone else's current requirements. The dynamic sector of new and growing SMEs, in particular, is highly dependent on this flexible, pay-as-you-go model for commercial space – one of its most fundamental inputs – and thus on an appropriately funded and financed CRE industry. CRE is a capital-intensive business, and requires sensible access to equity and debt capital. It is therefore vulnerable to the consequences of regulations designed either to protect investors or to protect financial stability. In important respects, CRE is also very closely connected with infrastructure – another central focus of CMU. There are overlaps between these two sprawling and rarely-defined economic sectors (especially in the context of social infrastructure such as accommodation for students, the elderly and others who rent rather than own their home, healthcare and educational facilities). More generally, infrastructure and CRE render each other possible, or essential – a symbiotic relationship that is most obvious in the urban regeneration context, where transport, social infrastructure and public realm are required by, can unlock, or are wholly or partly paid for by private CRE investment. For those investing capital, infrastructure and CRE share key characteristics, providing stable, secured income over the long term through productive and socio-economically useful investment. A number of European insurers have brought their infrastructure and CRE investment management businesses together into a "real assets" division to exploit the available synergies and complementarities of the two asset classes. Debt is often essential for financing capital expenditure, whether to retrofit or refurbish an existing building, to redevelop a brownfield site, or to deliver new buildings. Debt also facilitates many of the changes of ownership that stimulate improvements in buildings while also allowing the price discovery on which investment markets rely. Moderate levels of debt secured on CRE collateral can be very low risk, but lending is often pro-cyclical – and the evidence shows that large sums are often lent aggressively in a highly competitive environment during the exuberant phase of the cycle. There is a role for regulation to play in ensuring that systemically important financial institutions provide the lower risk debt that the CRE sector needs in order to serve the economy, while discouraging them from excessively risky lending (which should instead be the preserve of lenders that are not systemically important). A more sustainable flow of credit across the cycle would also be better for the CRE industry than alternating bouts of excess liquidity and credit drought. Our main concern as regards post-crisis financial regulation is that little attempt appears to have been made by regulators to approach CRE and CRE debt markets in a holistic or strategic way. Policy seems to have been guided by a generalised sense of mistrust or hostility towards CRE debt, with little appreciation of the vital role it plays in the real economy by financing our basic urban infrastructure. Financial regulators focusing on particular products or institutional sectors of the financial system have usually treated CRE debt as either peripheral or problematic. Our efforts to encourage a broader perspective on this sector, including the potential unintended and cumulative effects of regulatory interventions developed in different silos, have mostly fallen on deaf ears. We therefore welcome the Commission's Call for Evidence on precisely this subject, and hope that it will not dismiss CRE and CRE debt considerations as peripheral.

Probably the most obvious regulatory errors relate to commercial mortgage-backed securities (**CMBS**), which policymakers have so far failed to recognise as a functional component of the broader CRE debt market. Regulators have grossly overstated the risks of CRE securitisation: in reality, most CMBS-related issues arise from the underlying loans and have nothing to do with securitisation – witness the far worse problems still afflicting many of Europe's banks, whose CRE lending was never intended to be securitised. At the same time, regulators have failed to recognise the potential benefits: CMBS is more or less the only part of the CRE debt market that offers transparency and comparability of information and secondary market liquidity; in addition to providing a risk transfer mechanism that can diversify CRE exposure away from the banking system, while providing a valuable means of connecting capital seeking CRE debt returns with CRE businesses seeking to borrow to fund their economically and socially useful activities.

The capital framework under Solvency II is the most egregious example of these regulatory miscalculations. The more principles-based approach to securitisation culminating in the STS securitisation proposals represents a huge improvement, but unfortunately closer inspection shows that CMBS will still be excluded from the rehabilitation effort, whether because of unreasoned hostility or because of a continuing failure to understand this asset class. The imposition of a maximum concentration risk limit of 1% exposure to any borrower is the most obvious example of a criterion that is entirely misconceived for CMBS being used, in effect, to exclude it from STS benefits.

Finally, one general point in relation to the responses below is that there is very little empirical or quantitative data relating to CRE debt, and for that reason our representations are mostly qualitative, based on our knowledge of the asset class and the market and on logic. Of course, this information deficit should trouble policymakers at least as much as it troubles us: how can you hope to supervise and regulate, whether to protect investors or financial stability, if you don't have robust, comparable and timely information that allows you to diagnose risks and understand behaviours?

A UK CRE industry initiative has been promoting a number of recommendations for how the resilience of the financial system to the CRE cycle might be strengthened – the first recommendations in its 2014 report, A Vision for Real Estate Finance in the UK, are for regulators to create a comprehensive loan-level database with controlled public access, and to develop sufficient CRE expertise to ensure they can use the information it provides. We refer to that report in some of our responses, and strongly encourage you to read it. The Bank of England has supported the initiative, recently specifically endorsing the loan database proposal. The recently published ESRB report on CRE and financial stability acknowledges many of the issues, including the information deficit.

Submissions of CREFC Europe in response to the European Commission's Call for Evidence on the EU Regulatory Framework for Financial Services

Issue 1: Unnecessary regulatory constraints on financing (2 examples)

Example 1: Overall regulatory approach as it affects capital flows into commercial real estate
Relevant provisions
Various
Summary
It is impossible to imagine Europe's towns and cities without commercial real estate (**CRE**). Even leaving aside the areas where CRE overlaps with infrastructure (aspects of housing supply, leisure, health and education facilities, etc.), offices, shops, manufacturing and logistics facilities are essential to the way developed human societies function. For many of the users of such space, the ability to rent it, rather than having to own it, is important, because it allows them to devote their own financial and human resources to their primary business, and to satisfy their changing need for premises flexibly. Professional CRE investors build, manage and maintain space so that ordinary businesses can pay as they go. For SMEs – particularly new and growing businesses – the existence of an efficient and effective CRE investment industry is critical. The "pay as you go" space it offers amounts to a quasi-financial service. CRE investors' ability to provide premises that meet the constantly fluctuating and evolving needs of occupiers and society depends on the availability of capital – both equity and debt. Both the financial crisis itself and the regulatory response to it have had significant impacts on the flows of equity and debt into CRE. On the debt side, in particular, the crisis revealed structural problems that needed to be addressed: concentration of risk in systemically important parts of the financial system (European banks), poor counter-cyclical risk management (excessive exuberant lending at the peak of the cycle with inadequate capital recognition of the risks) and lack of transparency (no robust, comparable or timely CRE debt information for regulators, market participants or investors). Regulatory failures compounded those problems before the financial crash. Unfortunately, from the CRE perspective, regulatory interventions since the crash have, in important respects, failed to address the actual problems, instead hitting the wrong targets (notably commercial mortgage-backed securities (**CMBS**) and low-risk CRE lending by banks). Further policy interventions (for example, to restrict interest deductibility in line with OECD BEPS Action 4 proposals, and to regulate shadow banking based on an unreasonably broad definition) could make matters a lot worse. The implications for the flow of credit to the real economy through CRE may not be felt in the near term, because investor appetite for the risk/return characteristics of CRE debt is strong: this is a cyclical industry, and just as poor supervision in the last boom exaggerated the severity of the recent financial crisis, the cost of deficient regulation now will only emerge later. There will certainly be undesirable consequences if we fail to adopt a more coherent and structured approach – rooted in better information, a counter-cyclical approach and resilience through diversity – to this economically important and systemically significant sector. A blueprint for what policymakers should be doing (which is mostly relevant for the EU level too) is set out in the 2014 UK industry report, A Vision for Real Estate Finance in the UK.
Evidence
CRE is a key component of Europe's economy. According to industry data from INREV and EPRA, it directly employs 3.8 million people and was responsible for EUR249 billion of annual investment in

Europe's built environment and EUR312 billion of gross value added to the EU economy in 2014. 40% of Europe's CRE is office space that is let to businesses, which benefit from the ability to invest their capital and their time doing what they do best, as well as from the flexibility to adjust their premises to their needs as they grow.

From an investment point of view, CRE offers a range of opportunities ranging from high risk, high return equity exposure to development or marginal assets, to low risk, fixed-return, secured senior debt exposure in stable, long-leased, income-producing assets (with many shades in between). Investors have long recognised the appeal of both equity and debt exposure to CRE. The equity investor base is diverse, including many listed companies, private companies and family offices, and non-listed institutional and private equity funds. By contrast, until the financial crisis, the European CRE debt market was overwhelmingly dominated by banks. Despite a degree of differentiation depending on the home jurisdiction and particular regulatory regime applying to different banks, there was limited diversity either in the products available to borrowers or in the responses of debt providers to market signals.

The threats posed by CRE and CRE debt – particularly with that concentrated financial system risk profile –to financial stability, and proposals for enhancing financial system resilience, have been extensively discussed in a 2014 UK industry report, *A Vision for Real Estate Finance in the UK*. It is recommended reading for any regulator who is concerned about (or would simply like better to understand) CRE risks, or whose actions affect CRE capital flows and credit markets.

As noted in that report, CRE is an inherently long-term, illiquid and capital-intensive sector, for two fundamental reasons.

- It takes time to build, alter or remove buildings to satisfy the constantly changing needs of businesses and investors. As demand fluctuates with the ebb and flow of broader economic cycles, CRE businesses risk anticipating it incorrectly. The non-fungible nature of CRE, where each building is unique in terms of the combination of its location, purpose, specification and age (and thus value) makes it even harder to anticipate demand accurately.

- Investing money directly into CRE takes much longer than investing in bonds, shares or derivatives – typically weeks or months rather than minutes (or less). Furthermore, transaction costs are high for CRE so longer hold periods are generally required before investors can expect to achieve a positive return.

The fact that the supply of buildings cannot be expected to match perfectly either the pace of occupier demand for space or the flow of capital into the sector means that a CRE cycle is inevitable. When rising demand for buildings cannot be met by increasing supply, values go up; and reduced demand is reflected in falling values, as buildings cannot suddenly be removed to restrict supply. Judging supply/demand cycles is an essential part of the skillset for CRE businesses and CRE investors: get the timing right, and you can see the value of your assets increase, but get it wrong and you can be stuck holding assets no-one wants. The economy benefits most when CRE market participants generally get it right, enabling markets to remain broadly stable; occupiers get the space they want (delivered at the right time and in the right locations), and capital is deployed into the sector at an appropriate pace.

The CRE cycle can be amplified by the way debt flows into the sector, especially when the sources of debt are concentrated and lenders are overwhelmingly likely to respond to market signals in the same way at the same time. Those vulnerabilities characterised the European market, which has been very slow to recover; contrast the US market, where far less risk was concentrated in the banking system, and institutional and private money played a far larger role, through direct lending, a well-developed CMBS market and a well-developed mortgage REIT market. Over the last decade or so, both Europe and the US saw excess debt liquidity drive CRE values up to unsustainable levels. Since the crash, Europe's undiversified and opaque market has suffered a protracted credit drought that continues to constrain its economic recovery, whereas the resilience of America's more diverse and transparent market facilitated a much speedier return to growth.

Unfortunately, European policymakers have misdiagnosed the weaknesses in European CRE debt markets. Diversification and risk transfer, including through CMBS (by far the most liquid and transparent form of CRE debt exposure, whatever its historic failings), can deliver greater resilience – but regulators have cast CMBS as the villain of the crisis. Lack of CRE finance market transparency, poor levels of expertise among regulators and pro-cyclical approaches among lenders and regulators alike are problems that need to be addressed urgently – yet regulators have shown little interest in tackling them.

Remedies

The European Commission should heed the calls from the CRE and CRE finance sectors for a more holistic and strategic recognition of their importance in Europe's economy and their role in how capital is invested. These are sectors with disproportionate economic importance and systemic significance for financial stability – regulators should not assume that, because of their relatively limited visibility or size, it is acceptable to make policy that affects them without consulting with their representative bodies, and without really understanding how they might be affected by policy interventions.

Proposals for STS securitisation need to be adjusted to ensure that well-structured, simple and transparent securitised CRE debt can qualify. CMBS needs to be nurtured back to a state of health from its increasingly marginal European CRE debt market share of 2% to 3% post-crisis, because there is no other existing mechanism capable of achieving such a degree of transparency, liquidity, comparability of information, diversification and risk transfer in Europe's CRE finance markets.

More broadly, provided they are pursued in a collaborative manner that engages the industry in a consultative way, the recommendations set out in A Vision for Real Estate Finance in the UK offer an excellent blueprint for ensuring that the economically critical CRE sector is appropriately and sustainably financed across the cycle without endangering the stability of the financial system. Despite the UK focus of that report, much of its analysis would apply at the European level as well. In brief, it recommends:

1) a focus on information, analysis and expertise, through (a) the creation of a mandatory, comprehensive CRE loan-level database with limited public access, (b) ensuring that regulators have appropriate expertise and insight internally and at their disposal through engagement with industry organisations, and (c) an industry focus on developing CRE lending qualifications suitable for a range of different roles in lending institutions, including those with portfolio-level credit and risk functions;

2) appropriate incentives, in particular (a) involving a move to a long-term value measure to replace market value for the purpose of determining loan-to-value (**LTV**) ratios used in risk assessment, and (b) better alignment between economic and regulatory risk/capital and better risk differentiation in regulatory capital requirements, as much to encourage low-risk lending as to discourage high-risk lending by banks; and

3) a deliberate effort to promote market stability, by (a) encouraging diversity in the sources of capital and the strategies used for its deployment, so that there is diversity of lender response to market signals, and (b) designing regulatory frameworks (including for regulatory capital) to work across the cycle, emphasising counter-cyclical incrementalism, consistency and predictability over

abrupt and disruptive judgment-based interventions.

The report is available here: http://www.ipf.org.uk/industry-involvement/a-vision-for-real-estate-finance-in-the-uk.html. We would be delighted to discuss with you how it might be able to assist regulators at the European level.

Example 2: Proposed European implementation of OECD Base Erosion and Profit Shifting project Action 4 on best practice recommendations for restricting interest deductibility for tax purposes

Provisions

Proposed EU legislation to implement OECD BEPS Action 4

Summary

It would be inappropriate to exclude from the sort of review contemplated by this Call for Evidence the implications of a tax measure that could significantly alter the cost of finance for European businesses, especially given that its potential impact goes a long way beyond the mischief at which it purports to be directed. In functional terms, such a measure would have effects comparable to financial regulation.

In common with many other national and international representative trade bodies, we have a number of serious concerns regarding the OECD's proposals to restrict interest deductibility by reference to a fixed ratio of EBITDA. These include:

- the fact that there is no protection for wholly domestic arrangements (which are not capable of giving rise to concerns regarding international base erosion and profit shifting),
- the fact that no distinction is drawn between connected party debt (which prima facie is a legitimate target of BEPS concerns) and genuine, commercial, third party debt (which is not a legitimate target, although arrangements for routing such debt through different jurisdictions might be),
- the fact that no allowance is made for economically critical, capital intensive sectors such as infrastructure and commercial real estate (**CRE**) that have a structural reliance on debt finance because their risk profile rarely allows pure equity funding to be viable,
- the lack of appropriate transitional arrangements, especially in relation to long-term asset classes like infrastructure and CRE where credit arrangements are often entered into on a long-term basis by reference to long-term income streams and on certain assumptions regarding the tax treatment of income and expenditure, and
- the fact that a link to EBITDA is inherently and dangerously pro-cyclical, because it would reduce deductibility (and increase the effective cost of debt) at precisely those points in the cycle when revenues are under pressure, threatening compliance with financial covenants and creating a wholly unnecessary risk of defaults, losses for lenders and insolvency for borrowers.

We absolutely recognise the value of international collaboration on tax matters – but we believe that it is not appropriate for the European Union to be tabling legislative proposals to implement EU-wide legislation of this kind, particularly when Member States have not yet had an opportunity to consult internally on their response. In our view, the European institutions should be primarily concerned with

ensuring that tax proposals of this kind do not further undermine the effective recovery and operation of Europe's financial system and the ability of European businesses to enjoy appropriate access to finance. Only after individual Member States have determined how, if at all, they wish to respond to the OECD's proposals, and agreed the extent to which they are willing to agree to tax harmonisation at the European level, would it be appropriate for the institutions to explore whether legislating on BEPS-related interest deductibility restrictions at the EU level might deliver additional benefits.
Evidence
There are many industry views on the record (including our own) regarding the OECD's BEPS proposals and their potential implementation at national level – we refer you, for example, to the response of the British Property Federation to the UK's recent consultation on Action 4. It would be a mistake, in this context, to imagine that increasing the cost of finance for the CRE industry would straightforwardly promote a fairer tax system: on the contrary, those who rent space (notably SMEs) depend on CRE developers and investors having reasonable access to finance for their own access to premises that are fit for purposes and affordably priced. CRE represents a quasi-financial input for most European businesses, and particularly for new and growing businesses, and a far more detailed and specific impact assessment is required before anyone can safely conclude that a tax raid affecting genuine third party finance and wholly domestic financing arrangements would serve the interests of Europe's economy.
Remedies
The European Union should delay any proposals for implementation at the EU level of proposals emanating from the OECD's BEPS initiative until Member States have themselves have an opportunity to consult fully at the national level, which is where tax sovereignty remains.

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Issue 2: Market liquidity (2 examples)

Example 1: CMBS and Solvency II, CRR and CMU proposals for STS securitisation
Provisions
Solvency II, CMU proposals relating to securitisation
Summary
Our comment relates to the impact of regulatory change on secondary market liquidity in commercial real estate (**CRE**) debt. The damage has been done to the market in securitised CRE debt (CMBS), and more damage may be done to market-based finance if the EBA's opening salvo on shadow banking is any guide (EBA/GL/2015/20 Guidelines under Article 395(2) CRR). The European CRE debt market is overwhelmingly private and opaque. Before the crisis, it was in essence a bank balance sheet business, with a small but growing distribution pipeline into the securitisation market (in the form of commercial mortgage-backed securities (**CMBS**)). Since the crisis, the market has diversified considerably, with new non-bank origination platforms, a more diverse loan syndication market and the emergence of a range of CRE debt funds. With CMBS marginalised, however, the market remains fundamentally private and opaque: neither regulators, investors nor market participants have access even to aggregated, market-level data based on consistent and comparable inputs from the sector as a whole. The crisis was preceded by a considerable amount of over-exuberant lending by banks that apparently forgot (and were allowed by their regulators to forget) that CRE values can go down as well as up. Almost all of that ill-advised lending was conducted by European banks for their own balance sheets, and the consequences haunt Europe to this day. Some risky CRE loans were securitised, rated and bought by investors in the capital markets. While it is unclear whether securitised loans performed significantly better or approximately in line with other CRE loans of similar vintage, there is no evidence that they performed worse. However, the mere fact that there is public data relating to CMBS that can be compared to other asset-backed securities appears to have led regulators to regard CMBS as the cause of the problems it revealed in the wider underlying CRE lending market. Specifically as regards CRE debt markets, the regulatory response should have been (a) to improve market transparency; (b) to create powerful, counter-cyclical incentives for banks to avoid high risk lending late in the cycle, without discouraging them from low risk lending in the early stages of the recovery; and (c) to encourage the development of a more diverse, liquid and resilient CRE debt market. Instead, by treating CMBS as the source of the problem, regulators have reduced market transparency and liquidity, rendering CMBS a niche product, rather than encouraging its re-emergence in a simpler, more transparent and robust form. The fact that CMBS liquidity was severely constrained in the depths of the crisis is not an argument against CMBS. Europe has no alternative, more liquid CRE debt product. Non-bank capital that might have been attracted to a new generation of post-crisis CMBS has instead gone into less liquid and less comparable products: new loan origination platforms, participation in the loan syndication market and allocations to institutionally managed or private equity CRE debt funds. Those products are all good additions to the CRE debt landscape, adding diversity and allowing capital to be connected to borrowers in the CRE industry. But secondary market liquidity is a victim of unjustified regulatory hostility to CMBS.

Evidence

As a general matter, there is little in the way of verifiable empirical evidence available, principally because the post-crisis financial services regulatory framework is so new. Some policy interventions are not even in place yet, but even for those that are, there has not yet been time to assess the impacts. The fact that CRE and CRE debt represent a relatively small, specialised and private element of the universe affected by post-crisis financial services regulation further complicates the assessment of impacts. Accordingly, where such evidence is unavailable we have deployed our knowledge of the CRE finance sector, anecdotal information from members and other industry contacts, and logical, qualitative analysis.

Regulators appear to believe that the crisis showed CMBS to be a fundamentally problematic product. As a result of that belief, they have adopted a very hostile stance towards CMBS in post-crisis regulation – from automatic classification as "Type 2" securitisation under Solvency II to effective exclusion from the proposed new "simple, transparent and standardised" (STS) label under Capital Markets Union.

In fact, regulators have fundamentally failed to understand three key things:

(a) The functional importance of CRE debt: we briefly summarised this in an earlier response. In short, CRE is an essential, enabling, and in many respects quasi-financial part of the real economy, as well as an important investable asset class; and it is only capable of providing space for occupiers and maintaining our urban infrastructure if the risk-taking equity is combined with cheaper, lower risk debt.

(b) The risks CRE debt can present to financial stability and how they might best be addressed without damaging the contribution of CRE to the economy: the central problem is the tendency of feedback loops to develop between the CRE cycle and the credit cycle, with a sorry history of lenders driving values up and over the peak, and finding themselves saddled with distressed loan books that take years to resolve. The UK industry report, A Vision for Real Estate Finance in the UK (available at http://www.ipf.org.uk/industry-involvement/a-vision-for-real-estate-finance-in-the-uk.html), made a series of recommendations for how financial stability can be protected while allowing a sustainable flow of credit to the CRE sector across the cycle.

(c) The evolving structure and characteristics of the CRE debt market from the investor perspective. In recent times, CRE lending has been the preserve of the banks in Europe – leading to concentration risk and a lack of transparency or liquidity that continues to afflict Europe's financial system and economy. However, investors have long understood the attraction of CRE debt, which provides an illiquidity premium over larger segments of the fixed income universe and security over physical assets.

Before the crisis, Europe was beginning to follow in the steps of the United States, developing a CMBS market that could allow non-originating investors to gain exposure to CRE debt in a more liquid form, with far greater transparency and diversification potential than other products could offer. While some CMBS issues suffered rating downgrades, defaults and, in a few cases, losses as a result of the crisis, CMBS in fact played almost no role in the CRE-related vulnerabilities of Europe's financial system. On the contrary, it provided a mechanism for risk transfer and dispersal, some degree of liquidity in an inherently illiquid asset class, and transparency and data in a fundamentally private and opaque asset class. To be clear, pre-crisis CMBS had significant shortcomings – but the crisis presented an opportunity for them to be identified and addressed. The regulatory insistence on punishing CMBS for problems in the underlying CRE lending market has (among other things) significantly reduced the scope for secondary market liquidity CRE debt products.

While the return of European banks to new origination is essential, it is surely in Europe's interests to promote a more diverse CRE debt market for the future. Investors certainly seem to think so. In the post-crisis low interest rate environment, many have been attracted by the stable, secured, long-term income that CRE debt can provide – especially institutional investors attracted by the illiquidity premium relative to comparable risk in more liquid asset classes. CMBS currently accounts for less than 5% of the European CRE debt market, and new issuance has been at very modest levels in recent years. Most of the interest from non-bank investors has manifested itself either through allocations to specialist CRE debt funds, or directly in the CRE loan market (setting up origination platforms, using joint ventures or segregated mandates, or participating in the syndication market).

There are obvious advantages to investing in CRE loans directly as compared to investing in CMBS, as the degree of influence and transparency in terms of loan terms is obviously greater, and the lack of an extra layer of intermediation reduces the risk of misaligned interests. However, there are also obvious disadvantages, in the form of concentrated risk, the lack of any external validation of underwriting akin to the rating process, the absence of any meaningful secondary market liquidity, and the absence of comparable performance data.

Remedies

In our view, both investor portfolios and financial stability would benefit if regulators encouraged informational transparency and counter-cyclical approaches (as recommended in [A Vision for Real Estate Finance in the UK]) in both the CRE lending and securitisation markets, rather than ignoring the former and penalizing the latter.

In the meantime, efforts to revitalise STS securitisation need to be recalibrated so that securitised CRE debt is not excluded altogether (whether by explicit diktat, or implicitly through the way qualifying criteria have been crafted). Instead, the opportunity should be taken to incentivise the principles of simplicity, transparency and (to the extent reasonably achievable in a fundamentally heterogeneous asset class like CRE) standardisation in the CRE debt securitisation market. The following specific comments may assist.

(a) Concentration limits (Article 243(2)(b) of the legislative proposal for a regulation amending the CRR). The proposed condition that no obligor (or group of connected obligors) should represent more than 1% of the aggregate value of exposures in the loan pool underpinning an STS securitisation makes no sense at all in the CMBS context. CRE loans are usually non-recourse to the borrower – investors' credit risk is on the tenants liable to pay rent under leases, not on the borrowers. If diversification of credit risk is felt to be important (and that case has not been made in relation to CMBS), it needs to be at the tenant level. Indeed, a single underlying borrower can be beneficial, if it means that the cash flows from different leases and CRE assets are cross-collateralised (as they cannot be where they belong to different borrowers).

(b) Credit quality (Article 243(2)(c)(ii) of the legislative proposal for a regulation amending the CRR). The condition that no commercial mortgage loan in the pool must have a risk weight under the Standardised Approach of more than 50% is inappropriate, unless the intention is to exclude CMBS, given that the normal risk weight for CRE loans (which are typically non-recourse and to unrated borrowers) is 100%. It would of course be possible to explore ways of controlling for credit quality in the CMBS context, and we would be happy to contribute to any such discussion – but there has been no such effort on the part of regulators.

(c) Refinancing risk (Article 8(9) of the legislative proposal for a securitisation regulation). The Commission's proposal adopted a very sensible form of words on this point, requiring that repayment to investors should "not depend, substantially, on the sale of assets securing the underlying exposures". This is a genuine risk area for CMBS, and it is right that a test should apply to control for how it has been managed. However, the Commission's sensible approach may not reflect the regulatory consensus. The EBA's earlier proposals contemplated an entirely unrealistic and unnecessary requirement that loans be fully self-liquidating, and the Council has included in its compromise text a recital (19a) explicitly stating that because of refinancing challenges facing some CMBS during the crisis, CMBS should simply be excluded from STS securitisation (a sorry return to the asset class-by-asset class approach of Solvency II). The Commission's approach is very much to be preferred.

Example 2: CRE debt funds and shadow banking regulation under CRR
Provisions
CRR (guidelines for limiting exposures to shadow banking entities)
Summary
Our comment relates to the impact on secondary market liquidity in commercial real estate (**CRE**) debt of the approach being taken by the EBA to shadow banking, specifically in its guidelines on limits on exposures to shadow banking entities under Article 395(2) CRR (see EBA/GL/2015/20). Various kinds of CRE debt funds have emerged since the crisis. Most originate or participate in new CRE loans, helping diversify CRE risk away from the banking system and providing a mechanism for non-originating capital to gain CRE debt exposure. A number of them specialise in junior or mezzanine debt, filling a gap in the higher-risk part of the market no longer attractive to banks that are (quite rightly) adopting a more conservative approach than they did before the crisis. Such funds are generally unleveraged and closed ended – yet for quite incomprehensible reasons the EBA proposes (in its guidelines under Article 395(2) CRR) that many such funds should fall within its definition of "shadow banking entities". Another category of CRE debt funds specialise in distressed debt. Europe is still dealing with the consequences of poor incentives and regulatory oversight that allowed very large CRE exposures to build up on bank balance sheets. These (mostly North American) funds have been an important part of the solution, buying up portfolios of non-performing loans at discounts to resolve them, freeing up bank balance sheets from legacy loans in the process. These funds generally do use leverage – but it would be short-sighted of European regulators to treat that as a problem (as the EBA's Article 395(2) CRR guidelines appear to do). These distressed debt funds are bringing liquidity to the CRE debt market and to the banking system.
Evidence
As a general matter, there is little in the way of verifiable empirical evidence available, principally because the post-crisis financial services regulatory framework is so new. Some policy interventions are not even in place yet, but even for those that are, there has not yet been time to assess the impacts. The fact that CRE and CRE debt represent a relatively small, specialised and private element of the universe affected by post-crisis financial services regulation further complicates the assessment of impacts. Accordingly, where such evidence is unavailable we have deployed our knowledge of the CRE finance sector, anecdotal information from members and other industry contacts, and logical, qualitative analysis. Distressed debt funds have provided liquidity by acquiring tens of billions of euros of non-performing and sub-performing loan portfolios from European banks and national asset management agencies, thereby allowing capital to be recycled and loans to be resolved so borrowers and assets in need of

capital expenditure, as well as lenders, can move on from the crisis.

While the return of European banks to new origination is essential, and continues to be supported by distressed debt funds, it is surely in Europe's interests to promote a structurally diverse CRE debt market for the future. CRE debt funds specialising in higher-risk, higher-return junior or mezzanine debt (as well as those channelling institutional money into senior debt, often on different, longer-term or fixed rate, terms, compared to what banks tend to offer) therefore also have a vital role to play, complementing bank credit for businesses and promoting system resilience through diversification. The participation of different sources of capital in CRE credit markets is very likely to increase pressure for better, comparable market information and secondary market liquidity.

Remedies

The EBA's proposals for limiting the exposure of European banks to shadow banking entities under Article 395(2) CRR (see EBA/GL/2015/20) need urgently to be reconsidered, to avoid destroying the healthy diversification that Europe's financial system has experienced since the crisis. The goal of monitoring and, where necessary, regulating and controlling the risks that shadow banking activities can pose to Europe's banks (or indeed in their own right) is an eminently sensible one. However, the EBA's proposals for achieving it hit the wrong targets (as discussed below in a different part of this submission).

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Issue 4: Proportionality and diversity (2 examples)

Example 1: CRE debt funds an shadow banking regulation under CRR
Provisions
CRR (guidelines for limiting exposures to shadow banking entities)
Summary
Various kinds of commercial real estate (**CRE**) debt funds have emerged since the crisis. Most originate or participate in new CRE loans, helping diversify CRE risk away from the banking system and providing a mechanism for non-originating capital to gain CRE debt exposure. A number of them specialise in junior or mezzanine debt, filling a gap in the higher-risk part of the market no longer attractive to banks that are (quite rightly) adopting a more conservative approach than they did before the crisis. Others channel institutional money into (often) longer-tenor and/or fixed rate senior loans. Such funds are generally unleveraged and closed ended, posing none of the risks potentially associated with shadow banking. The EBA nevertheless proposes (in its guidelines under Article 395(2) CRR) that such funds should fall within its definition of "shadow banking entities". Another category of CRE debt funds specialise in distressed debt. Europe is still dealing with the consequences of poor incentives and regulatory failure that allowed very large CRE exposures to build up on bank balance sheets as the last cycle approached its peak. These (mostly North American) funds have been an important part of the solution, buying up portfolios of non-performing loans at discounts to resolve them, restoring liquidity to the underlying property market and freeing up bank balance sheets from legacy loans in the process. These funds generally do use leverage – but it would be short-sighted of European regulators to treat that simply as a problem (as the EBA's Article 395(2) CRR guidelines appear to do). The leverage they use is what allows the underlying CRE exposure to leave the banking sector and (once those legacy loans are resolved) attract new capital investment again. The investors in CRE debt funds are institutional, and the capital may come out of a fixed income allocation (particularly likely if the fund invests in new senior lending), a real estate allocation (particularly likely if the fund invests in riskier mezzanine debt) or an alternatives allocation (perhaps most likely if the fund invests in NPLs). Particularly in the absence of an effective CMBS market (see next example), these funds play a vital role both in diversifying risk out of the banks and in connecting different sources of capital with CRE businesses seeking to raise finance.
Evidence
As a general matter, there is little in the way of verifiable empirical evidence available, principally because the post-crisis financial services regulatory framework is so new. Some policy interventions are not even in place yet, but even for those that are, there has not yet been time to assess the impacts. The fact that CRE and CRE debt represent a relatively small, specialised and private element of the universe affected by post-crisis financial services regulation further complicates the assessment of impacts. Accordingly, where such evidence is unavailable we have deployed our knowledge of the CRE finance sector, anecdotal information from members and other industry contacts, and logical, qualitative analysis. CRE debt funds set up to originate or invest in new or existing (performing) CRE debt are the most obvious form of market diversification in European CRE debt markets. In a low interest rate

environment and in the absence of a properly functioning CMBS market in Europe (as to which see next example), CRE debt funds have allowed a range of institutional investors from Europe, North America, and the rest of the world to put capital to productive use in European CRE markets and obtain exposure to the corresponding risk and returns.

For the most part, these funds are purely equity funded, unleveraged and closed ended, lending out the capital raised from their investors for a term that will allow them to return it to their investors at the end of the life of the fund. Even though they undeniably engage in credit intermediation, they exhibit none of the risk characteristics associated with shadow lending identified by the FSB or the EBA (maturity transformation, liquidity transformation, leverage, 'run' risk, etc.). It is unclear, therefore, why EBA proposes in its Guidelines under Article 395(2) CRR to treat them as "shadow banking entities". To be clear, for the purposes of those guidelines, this error of judgment is not important: as these funds do not borrow, limits on European banks' exposures to them are irrelevant. However, we are concerned that once a European regulatory definition of "shadow banking entities" is in place, it will be 'recycled' and used for different purposes in the future. The consequences of such recycling are difficult to predict at this stage, but they will be accidental and may be undesirable.

Distressed debt funds have provided a very straightforward and timely (and indeed probably cyclical) avenue for dispersing and resolving the hundreds of billions of euros of legacy debt that has been clogging up European bank balance sheets and the national asset management agencies created as a first stave in recapitalising the banks. They have not been a source of new debt for business, but they have allowed banks to start lending again. This has been possible because of the private institutional capital that has been willing to take the risk of investing in these funds, and the finance these funds have been able to raise to optimise their risk profile and the returns for equity investors.

Their use of leverage (and that characteristic alone) means that distressed debt funds are clearly a more legitimate target of shadow banking regulation (and would rightly fall within the wider universe of activities that should be monitored with a view to understanding and managing shadow banking risks). However, regulators must not forget the crucial role these funds have played, and continue to play, in allowing Europe to restore a semblance of functional normality to its banking system. A balanced and proportionate response is essential.

Remedies

CRE debt funds are a vital vehicle for the gradual diversification of European CRE debt markets. While they undeniably engage in credit intermediation, they exhibit none of the risky characteristics associated with the need for shadow banking supervision. For that reason, it is inappropriate to categorise them as "shadow banking entities" for the purposes of the EBA's Guidelines under Article 395(2) CRR or (more importantly) for any other purposes. So characterising them risks undermining tentative moves to a more diversified European CRE debt market.

Distressed debt funds active in (among other areas) CRE NPLs have played, and continue to play, an essential part in allowing European banks and European sovereigns to recycle capital tied up in pre-crisis loans, and resolving loans that have paralysed businesses and investment in Europe's built environment for years. They generally exhibit one risk characteristic associated with the need for shadow banking supervision, namely their use of leverage. It is important that European regulators balance whatever risks they perceive in that use of leverage against the undoubted benefits of the activity these funds are undertaking, helping drag Europe's banks and its economy out of the prolonged slump triggered by the crisis. While these funds plainly fall within the wider universe of entities that should be monitored for the purposes of understanding and controlling shadow banking risks, it is arguably counterproductive and disproportionate simply to brand them as "shadow banking entities".

Example 2: CMBS and Solvency II, CRR and CMU proposals for STS securitisation
Provisions
Solvency II, CRR, CMU proposals relating to securitisation
Summary
It seems clear from their CRE blind-spot in CMU that European policymakers have not yet understood the importance to the European economy of commercial real estate (**CRE**), or the importance of the (equity and debt) capital that finances it. Worse, while they cannot fail to appreciate some of the risks that CRE debt exposures can pose for those holding them and for financial stability, financial regulators have fundamentally misdiagnosed the problems that the crisis revealed in CRE lending practices and in the CRE debt market's structure in Europe, somehow concluding that commercial mortgage-backed securities (**CMBS**) are to blame. As a result of that error, post-crisis regulation specifically affecting capital flows into CRE (as distinct from broader regulatory efforts to ensure banks are better capitalised, for example) has in important respects missed its mark. Instead of promoting solutions to the risk factors in the CRE debt market (concentration in the banking system, lack of counter-cyclical risk management, lack of transparency), regulation has tended instead to create new distortions, mostly ensuring that capital seeking CRE debt returns prefers private and less transparent products over CMBS. The broad investor base for CRE debt has brought about diversification (principally through CRE debt funds and distressed debt funds and through a much more diverse loan syndication market than existed pre-crisis). Unfortunately, however, ill-considered regulatory distaste for CMBS has caused that most liquid, comparable, transparent and diversified of CRE debt products to become little more than a niche market. It would be better to foster a sustainable recovery in CRE debt securitisation through a new generation of simpler, more transparent and more comparable CMBS – something that it is still not too late to achieve through the STS securitisation initiative, if corrections to the proposals are made.
Evidence
As a general matter, there is little in the way of verifiable empirical evidence available, principally because the post-crisis financial services regulatory framework is so new. Some policy interventions are not even in place yet, but even for those that are, there has not yet been time to assess the impacts. The fact that CRE and CRE debt represent a relatively small, specialised and private element of the universe affected by post-crisis financial services regulation further complicates the assessment of impacts. Accordingly, where such evidence is unavailable we have deployed our knowledge of the CRE finance sector, anecdotal information from members and other industry contacts, and logical, qualitative analysis. Regulators appear to believe that the crisis showed CMBS to be a fundamentally problematic product. As a result of that belief, they have adopted a very hostile stance towards CMBS in post-crisis regulation – from automatic classification as "Type 2" securitisation under Solvency II to effective exclusion from the proposed new STS securitisation label under Capital Markets Union. In fact, regulators have fundamentally failed to understand three key things: (a) The functional importance of CRE debt: we briefly summarised this in an earlier response. In short, CRE is an essential, enabling, and in many respects quasi-financial part of the real economy, as well

as an important investable asset class; and it is only capable of providing space for occupiers and maintaining our urban infrastructure if the risk-taking equity is combined with cheaper, lower risk debt.

(b) The risks CRE debt can present to financial stability and how they might best be addressed without damaging the contribution of CRE to the economy: the central problem is the tendency of feedback loops to develop between the CRE cycle and the credit cycle, with a sorry history of lenders driving values up and over the peak, and finding themselves saddled with distressed loan books that take years to resolve. The UK industry report, A Vision for Real Estate Finance in the UK (available at http://www.ipf.org.uk/industry-involvement/a-vision-for-real-estate-finance-in-the-uk.html), made a series of recommendations for how financial stability can be protected while allowing a sustainable flow of credit to the CRE sector across the cycle.

(c) The evolving structure and characteristics of the CRE debt market from the investor perspective. In recent times, CRE lending has been the preserve of the banks in Europe – leading to concentration risk and a lack of transparency or liquidity that continues to afflict Europe's financial system and economy. However, investors have long understood the attraction of CRE debt, which provides an illiquidity premium over larger segments of the fixed income universe and security over physical assets.

Before the crisis, Europe was beginning to follow in the steps of the United States, developing a CMBS market that could allow non-originating investors to gain exposure to CRE debt in a more liquid form, with far greater transparency and diversification potential than other products could offer. While some CMBS issues suffered rating downgrades, defaults and, in a few cases, losses as a result of the crisis, CMBS in fact played almost no role in the CRE-related vulnerabilities of Europe's financial system. On the contrary, it provided a mechanism for risk transfer and dispersal, some degree of liquidity in an inherently illiquid asset class, and transparency and data in a fundamentally private and opaque asset class. To be clear, pre-crisis CMBS had significant shortcomings – but the crisis presented an opportunity for them to be identified and addressed.

While the return of European banks to new origination is essential, it is surely in Europe's interests to promote a more diverse CRE debt market for the future. Investors certainly seem to think so. In the post-crisis low interest rate environment, many have been attracted by the stable, secured, long-term income that CRE debt can provide – especially institutional investors attracted by the illiquidity premium relative to comparable risk in more liquid asset classes. CMBS currently accounts for a low single digits percentage of the European CRE debt market, and new issuance has been at very modest levels in recent years. Most of the interest from non-bank investors has manifested itself either through allocations to specialist CRE debt funds, or directly in the CRE loan market (setting up origination platforms, using joint ventures or segregated mandates, or participating in the syndication market).

There are obvious advantages to investing in CRE loans directly as compared to investing in CMBS, as the degree of influence and transparency in terms of loan terms is obviously greater, and the lack of an extra layer of intermediation reduces the risk of misaligned interests. However, there are also obvious disadvantages, in the form of concentrated risk, the lack of any external validation of underwriting akin to the rating process, the absence of any meaningful secondary market liquidity, and the absence of comparable performance data.

The regulatory insistence on punishing CMBS for problems in the underlying CRE lending market has not only wasted an opportunity to address those problems, but damaged diversification of CRE debt markets. CMBS has effectively become out of bounds for some types of investor (such as European insurers for whom Solvency II inexplicably makes owning a three year duration AAA rated CMBS bond more expensive in capital terms than owning bricks and mortar directly) who may otherwise have wished to use CMBS. For other investors, including North American capital specialising in CMBS and unaffected by Solvency II, the atrophied scale of the European CMBS market and the hostile regulatory environment for new issuance has rendered it uninvestable, at least for now.

Remedies

Efforts to revitalise STS securitisation need to be recalibrated so that securitised CRE debt is not excluded altogether (whether by explicit diktat as under Solvency II, or implicitly through the way qualifying criteria have been crafted, as in the STS securitisation proposals). Instead, the opportunity should be taken to incentivise the principles of simplicity, transparency and (to the extent reasonably achievable in a fundamentally heterogeneous asset class like CRE) standardisation in the CRE debt securitisation market. The following specific comments may assist.

(a) Concentration limits (Article 243(2)(b) of the legislative proposal for a regulation amending the CRR). The proposed condition that no obligor (or group of connected obligors) should represent more than 1% of the aggregate value of exposures in the loan pool underpinning an STS securitisation makes no sense at all in the CMBS context. CRE loans are usually non-recourse to the borrower – investors' credit risk is on the tenants liable to pay rent under leases, not on the borrowers. If diversification of credit risk is felt to be important (and that case has not been made in relation to CMBS), it needs to be at the tenant level. Indeed, a single underlying borrower can be beneficial, if it means that the cash flows from different leases and CRE assets are cross-collateralised (as they cannot be where they belong to different borrowers).

(b) Credit quality (Article 243(2)(c)(ii) of the legislative proposal for a regulation amending the CRR). The condition that no commercial mortgage loan in the pool must have a risk weight under the Standardised Approach of more than 50% is inappropriate, unless the intention is to exclude CMBS, given that the normal risk weight for CRE loans (which are typically non-recourse and to unrated borrowers) is 100%. It would of course be possible to explore ways of controlling for credit quality in the CMBS context, and we would be happy to contribute to any such discussion – but there has been no such effort on the part of regulators.

(c) Refinancing risk (Article 8(9) of the legislative proposal for a securitisation regulation). The Commission's proposal adopted a very sensible form of words on this point, requiring that repayment to investors should "not depend, substantially, on the sale of assets securing the underlying exposures". This is a genuine risk area for CMBS, and it is right that a test should apply to control for how it has been managed. However, the Commission's sensible approach may not reflect the regulatory consensus. The EBA's earlier proposals contemplated an entirely unrealistic and unnecessary requirement that loans be fully self-liquidating, and the Council has included in its compromise text a recital (19a) explicitly stating that because of refinancing challenges facing some CMBS during the crisis, CMBS should simply be excluded from STS securitisation (a sorry return to the asset class-by-asset class approach of Solvency II). The Commission's approach is very much to be preferred.

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Issue 5: Excessive compliance costs and complexity (1 example)

Provisions
AIFMD (Directive 2011/61/EU on Alternative Investment Fund Managers, and relevant implementing measures)
Summary
The EU's Alternative Investment Fund Managers Directive (**AIFMD**), which came into full effect in July 2014, established harmonised rules for the management and marketing of all alternate investment funds (**AIFs**) in Europe. Under the directive, most managers of non-listed commercial real estate (**CRE**) funds in Europe are subject to far-reaching and costly requirements regarding their structure and operations and must obtain authorisation from their national financial regulators. Following authorisation, managers may obtain a passport to manage and/or market EU funds in other EU Member States. Inconsistent interpretation and implementation of certain AIFMD requirements by Member States increase the costs and complexity of compliance for many firms in the CRE sector. In particular, "gold plating" of requirements related to obtaining or exercising passporting authority in a number of Member States, including excessive fees and add-on requirements, are a problem. When Member States charge additional fees, they are frequently intransparently calculated, can change unpredictably and vary widely between those Members States that charge fees. Inconsistent definitions of important concepts such as "professional investor", "material change" and "marketing" among Member States also create unnecessary costs and complexities which significantly reduce the expected benefit of AIFMD. In addition, the Commission adopted certain AIFMD Level 2 measures that rejected ESMA's recommendations, effectively substituting its own judgment for that of the experts without any explanation to the public or the industries affected and without any opportunity for further consultation. This unfortunately also unfairly added costs and complexity that could have been avoided.
Evidence
As a general matter, there is little in the way of verifiable empirical evidence available, principally because the post-crisis financial services regulatory framework is so new. Some policy interventions are not even in place yet, but even for those that are, there has not yet been time to assess the impacts. The fact that CRE and CRE debt represent a relatively small, specialised and private element of the universe affected by post-crisis financial services regulation further complicates the assessment of impacts. Accordingly, where such evidence is unavailable we have deployed our knowledge of the CRE finance sector, anecdotal information from members and other industry contacts, and logical, qualitative analysis. Complying with AIFMD has undoubtedly created significant new costs for many fund managers. In 2014, the European Association for Investors in Non-listed Real Estate Vehicles, INREV, conducted a survey and asked real estate fund managers to give their views on how AIFMD has affected, and is expected to continue to affect, them. An overwhelming majority answered that the costs of AIFMD implementation are very significant; however, few were able to realise the full anticipated benefits of passporting.

The costs of AIFMD implementation result from revising and adapting remuneration policies and procedures, marketing strategies, investment strategies, and reporting and internal reorganisation. The scale and scope of the new requirements were daunting for many fund managers at the early stages of preparing for AIFMD compliance, with the associated costs being particularly burdensome. It is important to recognise that many affected firms are small teams with the kind of back-office compliance function to which institutionally managed firms have access. The quid pro quo for the additional costs of AIFMD are supposed to be the benefits produced from the ability to manage and market funds throughout the EU under an AIFMD passport. However, these benefits have been elusive so far.

In its opinion to the European Commission in July 2015, ESMA acknowledged the still-disappointing results of AIFMD passporting. In particular, ESMA highlighted "gold plating" of some requirements related to obtaining or exercising passporting authority in a number of Member States, including excessive fees and add-on requirements. ESMA also noted that inconsistent definitions of important concepts such as "professional investor", "material change" and "marketing" among Member States, which are creating real obstacles to the smooth functioning of the passporting system in Europe and should be addressed.

ESMA’s conclusions are consistent with our members’ overall experience with AIFMD passporting to date, which must be characterised as disappointing. It remains unclear which of these add-on requirements are understandable start-up glitches and which are long-term difficulties potentially thinly disguising a desire by Member State regulators to create practical barriers to entry by non-domiciled fund managers authorised in other Member States wishing to manage or market funds in their country. In any case, these obstacles indisputably create unnecessary costs and complexities for real estate fund managers.

In contrast to AIFMD, the passport regimes under the EuVECA and EuSEF regulations are a much swifter, less burdensome process. Under the EuVECA and EuSEF Regulations, the EuVECA or EuSEF manager notifies its home Member State competent authority of its intention to manage and/or market an EuVECA or EuSEF, the home competent authority checks the EuVECA or EuSEF meets the requirements of the applicable regulation and notifies the relevant competent authorities in the host Member State. These host Member State competent authorities have no ability to charge the manager additional fees, insist on a detailed review of the application and the fund documents or insist on the appointment of additional, local service providers.

To date, the desired outcome of a single European market for alternative investment fund management seems far from being realised. The inconsistent and in some cases egregious imposition of fees in order to register and maintain a passport, and the timing implications of obtaining a passport while trying to work with the typical launch process for a closed-ended fund that normally requires investors to receive and negotiate draft documents, makes conducting appropriate pre-marketing and finalising documentation in a manner consistent with the passporting process extremely costly, complex and challenging.

Also related to the issues of AIFMD costs, are the AIFMD Level 2 regulations, which were developed after lengthy public consultation and careful deliberation by ESMA, including a series of consultation and workshops with stakeholders. The process was efficient, transparent and well managed, with ESMA providing clear explanations for adopting or rejecting stakeholder contributions and recommendations. However, in at least at least two very notable cases, the Commission issued Level 2 regulations that rejected ESMA’s recommendation, effectively substituting its own judgment for that of the experts without any explanation to the public or the industries affected and without any opportunity for further consultation. This approach is not good practice for rule-making, and added unnecessary costs and complexity, while also reducing business confidence and certainty.

Remedies
The functioning of the AIFMD passporting system should continue to be improved through more consistent Member State definitions of critical terms. In addition, the “gold plating” and addition of unjustified fees and requirements by Member States should be prohibited, or at least actively discouraged. It would promote the achievement of CMU, as well as assisting European managers and investors, if the AIFMD passport operated in the same way as the EuVECA and EuSEF passports. In order to enhance the CMU, it would be helpful if the Commission could provide for one, consistent passport regime by way of a regulation which has direct effect on Member States and does not accommodate gold plating or the charging of additional fees. Related to the development of Level 2 measures generally, where the Commission deviates in material way from advice given by the European Supervisory Authorities, the Commission should provide a detailed explanation to the European Parliament and Council. The explanation should clearly state the reasons for deviating from the original advice and should be made available to the public. In order to avoid a repetition of such examples in the future, we believe that closer scrutiny by higher-level officials in the Commission is necessary in cases where material changes are being introduced by the Commission to advice of a European Supervisory Authority.

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Issue 6: Reporting and disclosure (1 example)

Provisions
EMIR (the European Market Infrastructure Regulation, Regulation No. 648/2012 EU on OTC derivatives, central counterparties and trade repositories)
Summary
The EU's European Markets Infrastructure Regulation (**EMIR**) establishes requirements related to the use of derivatives, including reporting and in some cases central clearing and cash collateral posting. For real estate fund managers that use interest rate swaps and currency swaps to manage their risk from interest rate and currency fluctuations, the regulation's requirements can be burdensome and, in some cases, expensive, while arguably offering only marginal benefits to regulators seeking to monitor and control systemic volatility.
Evidence
As a general matter, there is little in the way of verifiable empirical evidence available, principally because the post-crisis financial services regulatory framework is so new. Some policy interventions are not even in place yet, but even for those that are, there has not yet been time to assess the impacts. The fact that commercial real estate (**CRE**) and CRE debt represent a relatively small, specialised and private element of the universe affected by post-crisis financial services regulation further complicates the assessment of impacts. Accordingly, where such evidence is unavailable we have deployed our knowledge of the CRE finance sector, anecdotal information from members and other industry contacts, and logical, qualitative analysis. While we do not dispute the need for trade reporting for financial firms, we believe that EMIR has created a disproportionate operational and regulatory burden on non-financial firms that enter into derivative contracts for sound risk management purposes. The level of complexity that has been created by EMIR makes it very difficult for small fund managers to understand and comply with the regulation. A particular problem is the reporting obligation which, even if delegated (as they typically are by ordinary non-financial firms), remains a responsibility of the non-financial counterparty. For ordinary firms, the costs involved in checking trade repository data when the reporting obligation has been delegated and the difficulties of understanding the format of the reported data are significant issues. This is especially true for smaller firms trying to comply with the obligation to ensure the accuracy of the data reported by a party to which the obligation has been delegated. We consider that it would be consistent with the goals of the Better Regulation Package for the Commission to introduce single-sided reporting so as to remove these compliance burdens from non-financial firms. Alternatively, or in addition, "NFC-" firms should be exempted from trade reporting requirements in respect of trades falling below the ESMA clearing thresholds. On either approach, regulators would, of course, continue to capture the data from these trades from the reports of the counterparty.
Remedies
The regulatory objectives of gathering information about the size and scope of derivative transactions

can be effectively accomplished by requiring "single-sided reporting", meaning only one party to the transaction would need to report it, rather than both. This change would significantly lessen the burden on fund managers, many of which are themselves high-growth, innovative SMEs, which regulators are looking to assist by lightening the admittedly heavy regulatory burdens on them.

Against this backdrop of complexity and cost, we believe the Commission should consider the insignificant level of systemic risk caused by small, retail firms (as per the definition under MiFID) conducting derivative transactions that are linked to commercial activity or treasury financing.

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Issue 9: Barriers to entry (1 example)

Provisions
AIFMD (Directive 2011/61/EU on Alternative Investment Fund Managers, including opinion on the functioning of the EU AIFMD and NPPRs and passport advice on the application of the AIFMD passport to non-EU AIFMs and AIFs)
Summary
The EU's Alternative Investment Fund Managers Directive (**AIFMD**), which came into full effect in July 2014, established harmonised rules for the management and marketing of all alternate investment funds (**AIFs**) in Europe. Under the directive, most managers of non-listed commercial real estate (**CRE**) funds in Europe are subject to far-reaching and costly requirements regarding their structure and operations and must obtain authorisation from their national financial regulators. Following authorisation, managers may obtain a passport to manage and/or market EU funds in other EU Member States. Inconsistent interpretation and implementation of certain AIFMD requirements by Member States increase the costs and complexity of compliance for many firms in the CRE sector.
Evidence
As a general matter, there is little in the way of verifiable empirical evidence available, principally because the post-crisis financial services regulatory framework is so new. Some policy interventions are not even in place yet, but even for those that are, there has not yet been time to assess the impacts. The fact that CRE and CRE debt represent a relatively small, specialised and private element of the universe affected by post-crisis financial services regulation further complicates the assessment of impacts. Accordingly, where such evidence is unavailable we have deployed our knowledge of the CRE finance sector, anecdotal information from members and other industry contacts, and logical, qualitative analysis. Complying with AIFMD has undoubtedly created significant new costs for many fund managers, relating to revising and adapting remuneration policies and procedures, marketing strategies, investment strategies, and reporting and internal reorganisation. The scale and scope of the new requirements were daunting for many fund managers at the early stages of preparing for AIFMD compliance, with the associated costs being particularly burdensome. Quite aside from the ineffective delivery of the quid pro quo (in the form of passported access across the EU), these compliance burdens inevitably create significant barriers to the growth of new or smaller firms that must be able to support substantial back office operations before they can cross the threshold for AIFMD authorisation. This is damaging not only for those firms, but also for dynamism, innovation and efficiency in the European fund management industry.
Remedies
Improvements to the effective operation of AIFMD passporting are needed, so that the additional burden of AIFMD compliance is easier to justify in economic terms. In particular, Member States should not be allowed to use administrative control to impose disproportionate costs or increased requirements on firms domiciled outside their own jurisdiction. In addition, a delegated act to allow non-EU countries meeting the eligibility criteria to take advantage of AIFMD passporting rights should be adopted without delay. Finally, it may be appropriate for the Commission to review the impact on Europe's alternative

investment fund management industry of the AIFMD framework, with a view to limiting the extent to which it operates as a barrier to entry for newer or smaller firms, and all the resulting damage to innovation and competitiveness in this market.

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Issue 10: Links between individual rules and overall cumulative impact (1 example)

Provisions
Generally (Solvency II, CRR, CMU, AIFMD, EMIR)
Summary
We strongly support recent recognition by EU institutions that there have been problems in this area, and initiatives (including through this Call for Evidence and through the 16 December 2015 provisional text of the proposed interinstitutional agreement on better regulation) to address them. It is unclear how rules on banking, insurance, asset management and other areas were intended to interact. From the point of view of one underlying part of the real economy, commercial real estate (**CRE**), there has been no sense of a controlling mind at the European level seeking to understand, let alone manage or direct, how capital flows to this sector work, how problems revealed by the crisis might best be addressed, and how different regulatory initiatives contribute towards the creation of a more stable and sustainable model for European CRE that does not pose unacceptable risks to financial stability (or, more generally, to lenders and investors).
Evidence
It has been very clear over the last few years that: 1) high level policy is made with little if any regard to the implications for CRE or CRE debt, those usually representing small parts of a wider policy target (examples include AIFMD, EMIR, Solvency II, CRR, CMU); 2) detailed regulation is made in a silo, where officials lack both the perspective and the mandate to see the bigger picture and consider how their decisions might impact a broader underlying part of the economy; 3) many regulators have prejudices regarding CRE debt – either simply regarding it as a tainted asset class by some kind of (poorly articulated and rather tenuous) association with the financial crisis, or more specifically based on a lack of knowledge about how the sector works, its role in the economy and the precise nature of the risks it can present to financial stability. We are aware of a number of recent initiatives (including at the ECB, the EBA, the ESRB, the European Commission, and EIOPA) where policymakers would plainly have benefited from specialist industry input in relation to CRE debt, but did not seek it and, in certain cases, refused it when it was offered. A contrary example exists in the UK, where the Bank of England has adopted an interested and encouraging approach to a major industry initiative to explore how the often problematic relationship between CRE and financial stability might be improved. The independent Real Estate Finance Group published a report in May 2014, following industry consultation, which put forward seven high level recommendations (supported by extensive analysis, discussion, evidence and explanation) for reducing the risk of damage to the financial system from future CRE market crashes, while safeguarding a sustainable flow of credit to the CRE sector across the cycle. The report is available here: http://www.ipf.org.uk/industry-involvement/a-vision-for-real-estate-finance-in-the-uk.html.

One of the central strengths of the report is its strategic and holistic approach, based on deep knowledge of the sector and a genuine desire to identify, understand and address problems. The Bank of England recently praised the initiative (see this October 2015 speech by its executive director for financial stability strategy and risk: http://www.bankofengland.co.uk/publications/Pages/speeches/2015/850.aspx) and specifically endorsed two of its most important recommendations: one relating to the creation of a comprehensive CRE loan database and the other to the adoption of a long-term value metric that might contextualise current market valuations of collateral and make loan-to-value (**LTV**) ratios more useful for lending risk assessment purposes (and ultimately for regulatory capital). They are now being taken forward in a different, more formal and representative industry structure, the Debt Group of the Property Industry Alliance (www.propertyindustryalliance.org), in which CREFC Europe is a full and active participant. We believe real improvements can be achieved through an appropriately consultative approach and strong industry participation in the process.

While we have advertised the Vision report (and the consultative, informed, holistic and strategic approach it reflects) to European officials and policymakers on numerous occasions, we have been surprised and disappointed at the lack of practical interest in exploring its proposals. How often do industry sectors conduct this kind of exercise and bring to European policymakers and regulators specific, evidenced and reasoned proposals for more effective regulation to achieve policy objectives in a way that should minimise unintended consequences?

Remedies

European policy and regulatory bodies wishing to understand or regulate CRE debt products, markets, or market participants should take advantage of industry initiatives designed to help deliver what are (or should be) their own policy objectives. More generally, they should engage more actively with the only European industry association representing and specialising in the CRE debt sector as a whole. We are at your disposal should you wish to follow this suggestion.

We believe a conscious effort in this regard on the part of policymakers is required, because CRE debt does not represent a major part of the business of many financial institutions; as a result, general consultations often fail to elicit CRE-specific feedback. Policymakers have a responsibility to ensure they are adequately informed about CRE debt, because the consequences of poor policymaking in this area are potentially significant for both the real economy and financial stability, and not merely for firms' CRE debt activities (which policymakers might reasonably choose to ignore if the firms themselves do not priorities them).

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Issue 11: Decisions (2 examples)

Example 1: Alternative Investment Funds
Provisions
AIFMD, EMIR, CRR
Summary
The core definitions in the AIFMD (in particular those of "alternative investment fund" (**AIF**) and "alternative investment fund manager" (**AIFM**)) were designed to regulate alternative investment fund management. The way those definitions applied in the context of commercial real estate (**CRE**) was always uneasy, because – unlike hedge and private equity funds – CRE investment is an activity that is carried out both in a funds context, and in other contexts. Regulators found it difficult to provide clear, reasoned explanations as to which parts of the CRE industry should be within scope and which outside (not least because of their own lack of knowledge about the CRE industry), although we believe pragmatic and appropriate ways of drawing that line have been found. However, the real difficulties began with the 'recycling' of those core AIFMD definitions for different purposes: for example, treating funds as "financial counterparties" under EMIR (even when, as in the CRE investment context, they are behaving in exactly the same way as ordinary businesses in using derivatives solely for prudent risk management); and as "shadow banking entities" for CRR purposes (regardless of their functional and risk characteristics). It is superficially attractive to use consistent definitions, but definitions developed for one purpose cannot always be used safely in a different context.
Evidence
The policy aims of the AIFMD oscillated during its gestation period between investor protection and managing systemic risk. Anecdotally, the definitions of "alternative investment fund" and "alternative investment fund manager" were designed to be very broad principally because policymakers were keen to ensure that all hedge funds should be captured – and hedge funds are notoriously difficult to define. Policymakers were also keen to ensure that private equity was caught, and as real estate came to be tainted (principally because of the very specific but frankly irrelevant problems of the US subprime residential mortgage bond market), there was an increased focus in capturing real estate funds too. However, policymakers never devoted the time and resource necessary to understand the real estate sector, and found it very difficult to provide clarity as to which parts of the sector should fall within the scope of the AIFMD and which should not, and why. It was as absolutely obvious that parts of it should fall outside the scope as it was that other parts should fall inside the scope; drawing a clear line across the sector was therefore necessary, but not at all straightforward – so the lack of clarity was problematic. Before the AIFMD was even finalised, work began on EMIR, where a distinction was to be drawn for the purposes of EMIR between financial counterparties and non-financial counterparties. It had been clear in the context of the regulation of fund managers that some real estate firms were in scope and others were out of scope. In the context of managing the risks posed by derivative markets, it was equally clear that, to all intents and purposes, all real estate firms (whether involving fund managers or not) used derivatives solely to hedge interest rate or similar risks with the goal of minimising cash flow

fluctuations that might prevent their net operating income from being sufficient to cover their financing costs. In other words, all real estate firms should be classified as non-financial counterparties.

Unfortunately, perhaps because regulators were keen to ensure that hedge funds be treated as financial counterparties, a simplistic, superficially cautious approach was preferred, and all AIFs were instead designated as financial counterparties. Industry pleas that this approach could lead to unintended outcomes in the CRE sector fell on deaf ears.

In its eagerness to adopt a (superficially cautious) approach and ensure that hedge funds are treated as "shadow banking entities" for the purposes of limiting EU banks' exposures to such entities, the EBA proposed that all AIFs should be designated "shadow banking entities". From the real estate perspective, this was an almost surreal proposal. The vast majority of real estate AIFs are borrowers, engaging in no bank-like activities. Even among those involved in credit intermediation, it is rare for shadow banking risk factors to be present.

Fortunately, after consultation, the EBA was persuaded to introduce certain limited exclusions to address the most egregiously bizarre consequences of its approach: AIFs that are not structured to conduct credit intermediation activity will not, after all, be treated as shadow banking entities. Unfortunately, Europe's financial sector is still set to be saddled with an approach that is heavy-handed, overly complicated and poorly targeted – it should fail any "better regulation" test. In particular, CRE debt funds will be classified as shadow banking entities even if they are closed-ended and are fully equity funded (meaning they present no shadow banking risks). While restrictions on bank lending will not directly affect funds that use no leverage, the concern is that European policymakers will 'recycle' this poorly constructed definition of "shadow banking entities" for other purposes in the future. The implications are difficult to predict, but may well include unintended consequences.

European regulators' instinct for taking a definition designed for one purpose and recycling it for a completely different purpose is hugely frustrating for industry, forcing business to waste considerable resources on battles that should not need to be fought – and sometimes on dealing with the consequences of this style of policymaking when those battles are lost.

Remedies

Policymakers and financial regulators must resist the temptation:

(a) to define terms in a lazy way that captures entities or products that they do not fully understand and for which they have not conducted appropriate cost/benefit analysis or consultation, simply on "better safe than sorry" grounds (the presumption should be for less regulation, not more) – real estate has repeatedly been a victim of this kind of policymaking; and

(b) to recycle definitions without fully exploring the extent to which they are fit for the new purpose to which they are proposed to be put; there is much to be said for consistent definitions, but only when they are appropriate.

AIFMD definitions in particular should not be recycled without proper consideration, cost/benefit analysis and consultation regarding each affected constituency – starting with the EBA's use of those definitions in its Guidelines under Article 395(2) CRR.

CRE as a sector has been particularly vulnerable in this regard, because it accounts for a small part of the financial services industry, and financial regulators tend to be aware of the systemic risks it can pose but not of the economic benefits it delivers.

Example 2: Securitisation
Provisions
CRR
Summary
The CRR "securitisation" definition, unaccompanied by pragmatic, purposive guidance, is liable to capture common kinds of commercial real estate (**CRE**) related financing that are plainly not the intended target of rules relating to securitisation. Two examples of this inappropriately wide scope are so-called "agency" commercial mortgage-backed securities (**CMBS**) and loan-on-loan financings. Informally, regulators have shown some sympathy concerning the potential impact of these rules on transactions to which they were never really intended to apply; but it is a poor regulatory framework that forces industry (and regulators) to find creative and costly solutions to technical problems needlessly and unintentionally arising from poorly written rules.
Evidence
Agency CMBS are, in essence, secured corporate bond issues. They involve no risk transfer by a bank or other lender, and indeed no pre-existing debt is securitised. Instead, one or more investment banks simply act as agent in facilitating direct access to the capital markets by a CRE or other property-rich business. Nevertheless, if the bond issue involves a number of tranches, as would commonly be the case, there is an obvious risk that the "securitisation" definition is engaged. Loan-on-loan financings refer to the way distressed debt funds are financed when they acquire non-performing loan (**NPL**) portfolios from European banks or national asset management agencies. There is typically a combination of (senior) third party debt from a bank and (subordinated) connected party debt from the fund or its investors, and the existence of different tranches of debt again arguably brings the "securitisation" definition into play. The sensible solution would have been for regulators to provide straightforward, public confirmations that transactions such as these are plainly outside the scope of what rules relating to securitisation are aimed at. Instead, it seems that regulatory pragmatism has been limited to a sympathetic approach towards attempts to structure solutions to securitisation requirements (notably in relation to risk retention) that should not apply at all to such cases.
Remedies
Where there are policy reasons for preferring a broad, sweeping definition, policymakers should not defer addressing legitimate boundary concerns until after the rules are finalised, when the scope for doing so is more limited and there is a temptation to resort to technical (and sometimes complicated and expensive) fixes. Regulators should be more willing to contemplate appropriate exclusions and exemptions: it is easy, but not always correct, to assert that doing so risks watering down the rules. In appropriate cases, regulators should adopt a pragmatic and purposive approach to producing guidance to resolve unnecessary commercial uncertainty in as helpful a way as possible. There is usually an economic cost to excessive regulatory zeal, so regulators should not unquestioningly follow a "better safe than sorry" approach. The role of the regulator is to achieve the correct result, and that will sometimes mean a

narrower definition, the incorporation of exclusions, or helpful clarificatory guidance.

A weakness with the European (as distinct from the national) legislative process is that there is no Minister and chain of officials with clear and specific responsibility for ensuring that legislative and regulatory outcomes are fit for purpose and strike the right balance in terms of costs and benefits. The multi-institutional structure of policymaking encourages a simplistic, responsibility-denying focus on delivery, without adequate accountability for the quality of what is delivered. This is a fundamental problem that needs to be addressed if public confidence in the EU is to be restored.

Specifically as regards the securitisation definition and these narrow but legitimate concerns from the CRE industry, we would welcome, at the very least, a more pragmatic approach to the scope of the definition, rather than merely to satisfaction of requirements engaged as a result of accidentally falling within its scope.

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Issue 12: Overlaps, duplications and inconsistencies (one example)

Provisions
CMU Action Plan (and in particular elements promoting long-term investment)
Summary
We welcome recent initiatives aimed at strengthening long-term investments in the European economy. However, we note that commercial real estate (**CRE**), which, like infrastructure, can be an attractive asset class for long-term institutional investors, has not received adequate attention and is only mentioned in passing next to infrastructure.
Evidence
We believe that the distinction and differentiated treatment between real estate and infrastructure is unjustified. It is, on the other hand, possible to distinguish between two broad categories of infrastructure. On the one hand is economic infrastructure, such as communication, transportation, and energy supply networks that typically require planning on a regional scale. Social infrastructure on the other hand includes homes, schools, offices, hospitals, retirement homes, retail facilities, leisure, theatres, sports facilities etc. and is typically more local in nature. Clearly investment in both economic and social infrastructure is desirable and necessary, and they have much in common. Both are long-term assets that are expensive to maintain, upgrade or replace, often requiring public sector involvement to ensure (or even fund) them, and both are essential elements of our built environment. Securing a steady flow of private sector capital to deliver and maintain them is important, particularly as less capital is available from traditional public sector sources. However, proposed regulatory changes risk creating disincentives to invest in long-term assets. While economic infrastructure is a relatively well established alternative asset class, some types of social infrastructure are only gradually coming to be regarded as part of the investable universe. The CRE investment industry is increasingly looking beyond its traditional core sub-sectors of retail, office and industrial buildings to invest in social infrastructure projects such as rental housing, student accommodation, leisure and sports facilities, healthcare facilities and care homes for the elderly. Because they can deliver stable, long-term income in much the same way as traditional CRE, they are increasingly attracting similar, long-term capital. There is, indeed, little difference in functional or economic terms (as well as from an investment perspective) between such assets and traditional CRE. Like infrastructure, CRE is an intrinsically long-term asset class as it has no fixed lifespan, but requires specialist management and maintenance, including periodic capital expenditure, if it is to remain operational and fit for purpose for users, and income-producing for investors, over time. This fact means that CRE is also a source of employment that reaches far beyond the construction phase, which combined with the physical assets represents a long-term investment in viable and sustainable communities throughout Europe. Infrastructure and CRE are interdependent: one is rarely useful and viable without the other. For instance, CRE assets (like social infrastructure) may not be sustainable in an area that lacks the appropriate transport and utilities infrastructure – while such economic infrastructure is unlikely to be financially viable in the absence of substantial investment in the land it seeks to benefit.

Remedies
Given the similarities, mutual dependencies and increasing overlap between different types of infrastructure and CRE, we believe that regulation should be broadly supportive of both rather than discriminating against CRE. Both underpin a strengthening European economy, growth and job creation, and both can benefit from (and benefit) the investment of private capital.

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Issue 14: Risk (1 example)

Provisions
Solvency II, CMU proposals relating to securitisation, etc.
Summary
Commercial mortgage-backed securities (**CMBS**) are a natural asset class for insurers to invest in, because they combine the characteristics of CRE debt with a degree of secondary market liquidity/tradability, diversification potential and comparability of information only available in the bond market. Unfortunately, the standard model under Solvency II imposes a massive capital charge penalty on CMBS, regardless of characteristics, relative to other forms of exposure to CRE. Holding a four year duration AAA-rated CMBS bond is not only many times more expensive than it would be to hold individual whole loans; it is twice as expensive as owning the building itself (50% compared to 25%). We have heard no plausible justification of that approach from EIOPA or anyone else. It is to be hoped that the new approach to securitisation under CMU will improve the position under Solvency II (which is much more important from both an economic and macro-prudential perspective than the treatment of CMBS exposures in a bank's books under banking regulation). However, the unwarranted hostility to CMBS that characterises the STS securitisation work stream offers little ground for optimism.
Evidence
CMBS is a mechanism for risk transfer and dispersal, offering a degree of secondary market liquidity in an inherently illiquid asset class, and a reasonably good level of comparability of data in a fundamentally private and opaque asset class. Pre-crisis CMBS had shortcomings (most evident in some of the issuance that was supported by loans written at the peak of the last cycle), but fundamentally CMBS is an excellent mechanism for institutional money to go into CRE debt, and for the origination capability of banks to feed the wider financial system rather than allowing risk to be concentrated in the banking sector. CMBS is an especially natural asset class for life companies, which can benefit from an illiquidity premium that is worth more, particularly in today's low interest-rate conditions, than the illiquidity for which it compensates investors. In the United States, insurers have long been a major investor in CMBS, and the underlying lending market has evolved to feature banks originating fixed-rate, ten year loans specifically for securitisation and distribution to insurance company investors. In Europe, CMBS was a relatively new product, having existed for only a few years, when the crisis began. In many ways, the crisis offered the perfect opportunity to learn from the mistakes that were made in first generation European CMBS and develop a more compelling product for institutional investors in the future. Institutional appetite for CRE debt has certainly grown since the crisis, but in ways that do not include CMBS. We welcome the emergence of insurers (and others) as direct lenders, as participants in the syndication market and as allocators of capital to CRE debt funds (whether managed by insurers or private equity fund managers). There are good reasons for insurers to pursue these kinds of CRE debt investment strategies, such as the control and transparency that lending without an intermediary can provide, or benefiting from a bank or fund manager's origination and underwriting platform and

specialist expertise.

However, there is not good policy reason for creating an almost insurmountable regulatory barrier that stops insurers from investing in the more tradable, diversifiable and comparable securitised form of CRE debt. Unfortunately, that is what EIOPA has done, and what Solvency II will continue to do unless there is a radical rethink to the capital charges attaching to different types of securitisation exposure relative to other relevant exposures. Regulation has created massive distortion in the CRE debt market, substantially overriding genuine economic and risk-related considerations in determining how capital flows to different products.

EIOPA's justification for automatically classifying CMBS as "Type 2" securitisation and attaching penal capital charges to it under the standard model is, essentially, that its volatility during the reference period was very high compared to other ABS asset classes. We cannot dispute that answer, but it addresses the wrong question. CMBS is functionally part of the CRE debt market, and CRE lending for their own balance sheets was a significant cause of the problems that many European banks still face today. What evidence is there that securitised CRE loans performed worse than CRE loans of the same vintage that were retained on bank balance sheets? What evidence is there that insurers (unlike banks) will be safer for investing in less transparent and tradable forms of CRE or CRE debt than CMBS? In the absence of such evidence, is it safe to drive European institutions away from CMBS? We have been surprised at policymakers' persistence, given the absence of any meaningful analysis to support their approach.

We are also troubled by the fixation in the Solvency II capital framework on duration risk, even though it is far less relevant a risk factor in CRE debt exposure than cyclical factors (perhaps best illustrated in research published by Bank of America Merrill Lynch over the last 12 months that analyses the performance of securitised European CRE debt). It is surprising and damaging that European policymakers should be so intent on deterring natural long-term investors like insurers from long-term exposures to long-term assets, especially when the evidence (to the extent any exists) suggests that such an approach will not reduce insurance sector or broader financial sector risk, but may reduce long-term investment in Europe's economy.

CMBS played almost no role in the CRE-related vulnerabilities of Europe's financial system. Some investors in CMBS have lost money; but many who bought CMBS at steep discounts during the worst of the crisis made stellar returns as cash flows performed much better than had been feared. There were undoubtedly some poor CMBS transactions at the peak of the crisis – but that was entirely in line with the excessive exuberance of the wider CRE lending market, and occurred at a time when investors and financial regulators (among others) were desensitized to risk.

Remedies

European regulators need to understand that the problems revealed by CMBS (the tiny fraction of the wider European CRE debt market that is public and visible) are overwhelmingly problems with CRE lending, not problems relating to securitisation. As in the wider economy, securitisation is part of the solution for CRE finance, not part of the problem.

Solvency II has already steered large amounts of capital from the insurance industry into less liquid and less visible forms of CRE debt. The enormous regulatory arbitrage driving these capital flows needs to be removed, allowing firms to make decisions based on economic, risk and investment considerations.

One part of the problem is the way "high quality" securitisation is defined. Solvency II does this in a particularly crude way, consigning entire asset classes to the (expensive) "other" securitisation bucket. The STS securitisation initiative has the potential to address that, but it needs to be smarter at dealing with the characteristics of particular asset classes (even unfashionable ones like CMBS) if it is to fulfil that potential. We have discussed in other parts of this submission the ways in which the STS criteria persist in smuggling asset class-by-asset class conditions into the framework through the back door. To take just one example, the borrower concentration risk limit of 1% may be sensible for securitisations of homogeneous, full-recourse consumer finance products, but it makes no sense at all in the context of heterogeneous, non-recourse CRE debt where credit risk is on tenants, not borrowers.

The other part of the problem is the extent of the cliff-edge between "high quality" and "other" securitisation (currently very large under Solvency II; significantly reduced in the banking context), but also between securitisation and other forms of relevant exposure. Regulators could go a long way towards reducing arbitrage risk without completely respecting capital neutrality. For a start, it is difficult to see why a AAA-rated CMBS bond should ever carry a higher capital charge than the buildings on which the loans underpinning that bond are secured.

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Issue 15: Procyclicality (1 example)

Provisions
CRR and embedded procyclicality in the 'slotting' framework
Summary
In mid-2015, the EBA consulted on criteria for assigning risk weights to specialised lending exposures. There are highly pro-cyclical aspects to the way slotting works, ranging from the way the guidelines direct particular factors and sub-factors to be taken into account, to the way the lack of responsiveness of the regime to low-risk lending drives affected banks towards the riskiest end of each slot in an effort to compete with other lenders. In connection with that EBA work, and also with a separate CRR-related work stream for the creation of a CRR definition of "mortgage lending value", detailed representations were submitted to the EBA identifying a variety of ways (large and small) in which the slotting framework could be made less pro-cyclical. Unfortunately, it seems that the EBA will prioritise the political conservatism of remaining close to existing (pro-cyclical) guidelines drawn from Basel (and incorporated in that framework before the financial crisis and at a time when few banks expected ever to have to live with slotting), over reducing pro-cyclicality (by adopting a more pro-active approach).
Evidence
For present purposes, we will identify two especially pro-cyclical features of the slotting regime. Slotting is especially relevant in the UK commercial real estate (CRE) finance market, because the UK financial regulator has required all UK regulated IRBA banks to use slotting for their UK income-producing real estate exposures. First, slotting relies on market value-based loan-to-value (**LTV**) ratios as a key risk metric. Market value-based LTV is, in fact, a very poor risk metric, because the denominator (the market value of the collateral) is highly volatile, in a pro-cyclical way. When market values are used, the difference between 50% LTV and 65% LTV at any given point is small, compared to the difference between 65% LTV just before the peak of the CRE cycle and 65% LTV at the trough of the CRE cycle. Yet the slotting criteria focus on the small difference and ignore the much bigger one. The independent UK industry report A Vision for Real Estate Finance in the UK, published in May 2014, made a number of recommendations for reducing damaging feedback loops between CRE and credit cycles. One of them is a proposal for the development of a long-term value concept to replace market value when lenders use LTVs in CRE lending risk assessment and, ultimately, for regulatory capital purposes. In substance, this long-term value concept would serve a similar function to mortgage lending value – but whereas mortgage lending value definitions have been developed by certain Member States for quite different purposes, the UK long-term value concept would be designed specifically with regulatory capital rules and counter-cyclicality in mind. At this stage, a number of approaches are under consideration, and it is not possible to predict which might be selected. Secondly, the "strong" slot to which the lowest risk weights attach covers a broad range of risks, and carries a risk weighting that reflects the riskiest end of the range. Banks subject to slotting are therefore at their most competitive at that riskiest end of the range, and cannot make themselves more competitive (against other banks that are not subject to slotting, as well as non-banks) by reducing risk.

There is no benefit in terms of risk weighting for enhancing the credit quality of a loan, for example by reducing LTV, improving interest or debt service coverage, or putting other measures in place. (The same problem exists for other slots, but it is most acute in the “strong” slot.) If the exposures of banks using slotting are concentrated at the riskiest end of the risk range covered by each slot, the inevitable consequence of a market correction is that banks need to find additional capital after the correction (when exposures score less well against the criteria). A counter-cyclical framework would increase capital requirements as the market rises towards its peak, not after it.
Remedies
In relation to the pro-cyclical reliance of slotting on (currently) market value-based LTVs, the EBA should ensure that (a) any CRR definition of “mortgage lending value” is broad enough to include an emerging UK “long-term value” concept pursuant to the Vision report; and (b) the slotting criteria specifically encourage the use of that concept, where it exists, in preference over market value, in LTVs. That remedy would also assist in relation to the second pro-cyclical issue identified above; but ultimately it is also necessary to increase the sensitivity of slotting to lower risk levels with appropriately low risk weightings. CRE lending can be very risky, but it can also be very safe (indeed, the success of Germany’s Pfandbrief, which benefits from a mortgage lending value-based LTV measure as gatekeeper, is testament to that). Regulatory capital rules should positively encourage banks to advance very safe loans. That would allow them to support economic activity, including counter-cyclically, without endangering financial stability. It would also create the foundation on which higher risk subordinated loans might be advanced by different, less systemically important lenders.