CREFC Europe

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By post and email

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Dear Dr Tang,

**Commercial real estate debt and securitisation in Europe**

**Draft report on the proposal for a regulation of the European Parliament and of the Council laying down common rules on securitisation and creating a European framework for simple, transparent and standardised securitisation and amending Directives 2009/65/EC, 2009/138/EC, 2011/61/EU and Regulations (EC) No 1060/2009 and (EU) No 648/2012 (COM(2015)0472 – C8-0288/2015 – 2015/0226(COD))**

There has been considerable public debate about your work in relation to the ongoing effort to revitalise securitisation markets in Europe, with many expressing understandable doubts as to whether some of your suggestions (such as much higher standard risk retention requirements) can really assist that effort. The focus of this letter is different.

We are writing to you to reiterate a number of important points about commercial real estate (**CRE**) and securitisation that we were disappointed to find were missing from your draft report 2015/0226(COD) referenced above. CREFC Europe is the industry association for the broader European CRE debt market and often, it seems, a solitary voice trying to help policymakers deal with this significant, complex and specialist part of the economy and financial system.

We hoped to express our concerns at the stakeholders' meeting you held in Brussels on 21 June, but CRE was not given a platform at the event, and our representative was not given an opportunity to comment from the floor. Accordingly, we are taking up your invitation to submit further written representations.

Despite their good intentions, we fear that policymakers are driving changes in the structure of CRE finance markets that will neither serve the needs of the economy, nor promote financial stability. **We want to help policymakers understand the role securitisation could play in enhancing the transparency, liquidity and stability of CRE debt markets as a whole.**

Appended to this letter is a short policy briefing on CRE debt, commercial mortgage backed securities (**CMBS**) and 'qualifying' securitisation that pre-dates your draft Report, but the contents of which remain valid. First, we would like to emphasise, through a number observations, that our views are broadly aligned with, not contrary to, your policy goals.

**<u>Securitisation (including for CRE debt) has a positive role to play in financing the European economy…</u>**

In Europe, banks tend to dominate loan origination, and also to retain most of the exposures they originate on their balance sheets. Reducing reliance on banks for financing the real economy is rightly a

central goal of CMU. Despite their strengths, covered bonds entrench the dominance of banks rather than reducing it, so cannot alone be the answer. Other sources of loan origination (private funds, peer-to-peer platforms and even insurance firms) cannot easily reach as much of the market as the banks.

Securitisation allows the underwriting and origination infrastructure of banks to be used to support securities through which exposures are transferred away from the most critical component of the financial system (banks) and into the hands of institutional investors (which may not wish to set up their own origination platforms, but may find the risk/return characteristics of securitisation bonds attractive). Securitisation also offers a range of different risk/return options, is tradable, and allows comparable information to be collected and made available to current and prospective investors with relative ease.

Being able to do all of that is especially important in a wholesale market like CRE, where lending activity is business-to-business, private and bespoke, and where the underlying asset class, property, is highly cyclical. **Historically, both risky loans and ineffective regulation are cyclical problems in this sector – and they arise in relation to lending activity, not because of any particular approach to retention or distribution of exposures (e.g. through loan syndication or CMBS).**

That point is illustrated by Europe's experience in the global financial crisis. While some CMBS may have performed badly, the challenges still faced by the financial sector are a function of exposures retained on bank balance sheets. European CMBS was never substantial enough to be systemic. **Continuing to concentrate CRE exposures within the banking system has implications for financial stability, and none of the alternatives to CMBS can de-risk the banks, or provide relative liquidity and transparency, as effectively as CMBS.** Promoting responsible and sustainable securitisation of CRE debt should be an important policy goal.

**…provided it learns from the mistakes of the past**

Parts of the securitisation market pre-crisis had problematic characteristics. Inherently complex transactions were not always documented in ways that anticipated the problems that might arise if the underlying loans did not perform. Due diligence was not always conducted as comprehensively as it might have been, a problem that may sometimes have been compounded by informational asymmetry and misaligned interests.

Specifically in the CRE context, as illustrated in the research sent with this letter, the quality of loan underwriting undoubtedly became less consistent and reliable towards the peak of the long cycle that ended when the global financial crisis struck, and some late-cycle CMBS transactions were handled less well than they should have been (by all parties concerned). Unlike covered bonds and securitisations of standardised retail financial products, CMBS lacked any quality control framework.

The industry has tried to address these issues. CREFC Europe coordinated an enormous effort by all parts of the European CMBS industry (including investors) to identify, understand and address the mistakes that the crisis revealed. Our Market Principles for Issuing European CMBS 2.0[1] were published in November 2012, setting standards against which subsequent issuance has been assessed.

**The market needs STS criteria specifically designed for CMBS**

In our view, it would be a mistake to exclude CMBS altogether from the STS securitisation framework. Instead, **policymakers should help improve the product (and thus the stability and effectiveness of the entire CRE debt market) by carefully calibrating STS to incentivise best practice in CRE securitisation.**

[1] These are available at https://www.crefc.org/uploadedFiles/CMSA_Site_Home/Global/CMSA-Europe/Committees/European_CMBS_20_Committee/Market_Principles_for_Issuing_European_CMBS2.pdf.

**We are confident this can be done, if policymakers focus on the nature of the product, the right risk metrics and transaction characteristics, and the available evidence.**

Relevant criteria should include maximum loan-to-values (**LTV**) and minimum interest cover ratio (**ICR**) and perhaps debt yields (the ratio of the net rental income to debt quantum). This letter is accompanied by a research paper that explores the available evidence and suggests such criteria, by reference to the historic performance of the loans underpinning European CMBS. By contrast, as discussed in the appendix, a minimum granularity criterion referencing borrowers make no sense at all in the CRE debt context, where credit risk depends on rental income from tenants rather than on the landlord/borrower.

**<u>CMBS has become a marginal, niche product in recent years</u>**

Lending to, and investment in, CRE (like lending to and investment in the wider economy) took a long time to recover from the credit drought that marked the global financial crisis. Since around 2013, insurers and other non-bank lenders, followed by banks, began to lend again, and Europe's CRE debt market is much more diverse today than it was pre-crisis. Regulation has been a very important factor in determining the shape and structure of this market, and the ways in which non-originating capital gains exposure to CRE debt. While certain regulatory interventions have had positive effects, others have not.

The relative capital charges imposed under Solvency II on different forms of CRE exposure are an example of a problematic regulatory intervention. Inappropriately high charges for "Type 2" securitisation exposures (including all CMBS) coupled with appropriately low charges for direct loan exposures have led many institutions to turn their backs on CMBS. Instead, they have set up their own origination platforms, made allocations to private debt funds and entered the loan syndication market. Each of these strategies has benefits, but they are all private, less visible to regulators, hard for investors to benchmark in the absence of comparable market data, and far less liquid than the bond market.

There are commercial reasons for market participants to be wary of CMBS – and there are things regulators could be doing to encourage the industry to address legitimate concerns and develop better standards. But why create a strong regulatory incentive that drives institutional money to prefer CRE debt exposure in loan format rather than securitisation bonds?

**<u>Securitisation transactions should be structured so that the interests of arrangers and issuers are aligned with those of investors</u>**

We see little evidence that misaligned interests were a decisive factor in the CRE and CMBS context. The performance of CRE loans of similar vintage appears to have been broadly comparable, regardless of whether they were (or were intended to be) securitised or otherwise distributed, or retained. If anything, securitised CRE debt appears to have performed better (as one would expect, given the additional diligence that securitisation entails).

Having said that, we recognise that asymmetrical information and misaligned interests are genuine, structural risks in securitisation (as in many other investment contexts, of course). Our view is that improved disclosure and reporting, better practice reflecting our CMBS 2.0 guidelines (mentioned above) and 5% risk retention provide an adequate solution.

**<u>CMBS is often perceived as a relatively high risk form of securitisation</u>**

In our view, little can be learned by comparing CMBS to securitisations of very different products; it is much more meaningful to **look at CMBS as part of the wider CRE finance market of which it forms a functional component**:

- CRE loans are a business-to-business product that is generally unregulated (unlike the consumer financial products that underpin many other ABS).

- Credit risk is usually mainly about tenants and rental flows, not the borrower (which is typically a single purpose property-holding entity) or its sponsor/ultimate owner (to which recourse is not normally available).

- Finally, granular CRE debt securitisations involving large numbers of loans present various challenges and are a long way from becoming an established feature of the European market. As a result, analysing most CMBS transactions requires specific due diligence of the underlying loans, assets and cash flows, rather than statistical analysis. That requires a different skill-set from that required for most other ABS asset classes.

As mentioned above and as previously submitted to policymakers, securitised CRE loans have experienced a significantly lower default rate than similar loans retained by banks and other institutions. One might also argue that the true default rate of other forms of securitisation (and covered bonds) is disguised by the substitution of performing assets for distressed assets (and the flip side of such bonds thereby performing better is that poorer quality assets remain within the banking system).

Investors in CMBS clearly need to understand the particular characteristics of the product and how to analyse the investment – principally because of the nature of CRE debt as the ultimate investment. But **simply excluding CMBS from the EU's proposed 'qualifying' securitisation framework offers no protection to investors or financial stability. Instead, it drives the capital seeking CRE debt returns into different (more private, less liquid, and less comparable) investment channels.**

We would therefore encourage you to consider putting forward amendments to allow responsible, well-structured CRE debt securitisations to benefit from the proposed STS securitisation framework. The appendix to this letter identifies the key issues that need to be addressed.

We hope you will consider the points made in this letter and in the appendix, and the discussion and analysis of the evidence on securitised CRE loan performance and risk in the attached research report.

You have noted (in your May 2016 working document) that "a set of clear rules for securitisation and a label for STS securitisation could support the revival of [the] market, but only if they are carefully calibrated". We agree, and we would encourage you to ensure that "careful calibration" allows sensible, well-structured CRE debt securitisation to qualify. We would be very happy to answer any questions and provide any assistance you may require.

Yours sincerely

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**Appendix: Qualifying securitisation criteria and commercial real estate finance / CMBS**

Sustainable and responsible securitisation markets have an important role to play in the commercial real estate (**CRE**) debt market, as they do in other parts of the financial system. Unfortunately, the criteria that international regulatory bodies have been developing to encourage simple and transparent securitisation ignore key aspects of the CRE debt market. As a result, an important opportunity to improve the resilience and diversity of CRE debt markets is likely to be missed. Here are the key points.

**CRE (and CRE finance) is a key part of the real economy.** CRE debt serves a functionally essential, enabling part of the economy – the CRE investment and development industry. That industry provides quasi-financial services to ordinary businesses – the ability to rent space flexibly is especially important for new and growing businesses. It is also an important investable asset class alongside fixed income and bonds. For the most part, CRE investors and developers can only provide space for occupiers and maintain our urban infrastructure if their risk-taking equity is combined with cheaper, lower-risk debt.

**CRE debt (not CMBS) can pose risks to financial stability.** As the recent financial crisis showed, there can be feedback loops between the property cycle and the credit cycle, with a threat to financial stability if lenders drive values up and over the peak, only to find themselves saddled with large distressed loan books that take years to resolve. But simply discouraging the flow of credit (or capital more generally) to CRE is not the right answer, because of the adverse impact on the quality and cost of premises available to business and the quality of our built environment more generally. A more CRE-literate approach was proposed by the independent UK Real Estate Finance Group in its May 2014 report, A Vision for Real Estate Finance in the UK, which makes seven (mostly geographically transferable) recommendations for protecting financial stability while allowing a sustainable flow of credit to the CRE sector across the cycle.

***An evolving CRE lending and debt-investing universe.*** 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 stable, long-term income with an illiquidity premium over larger segments of the fixed income universe, as well as security over income-producing physical assets. 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.

***A brief history of European CMBS.*** 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 during the crisis, CMBS was in fact almost irrelevant to 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. While pre-crisis CMBS had shortcomings, the crisis presented an opportunity for them to be identified and addressed, and the industry did just that, including through the development of CREFC Europe's Market Principles for Issuing European CMBS 2.0 (whose recommendations have generally been incorporated in post-crisis issuance).

***CMBS as part of the solution.*** CMBS currently accounts for less than 5% of the European CRE debt market, and new issuance post crisis has been at very modest levels. Most non-bank investors have sought exposure to CRE debt by setting up their own origination platforms, making allocations to specialist fund managers, using joint ventures or participating in the syndication market. While that diversification is welcome, it is unfortunate that regulatory hostility to CMBS is driving capital to favour direct exposures over CMBS. CMBS has unique attractions over direct CRE lending, such as better risk diversification and secondary market liquidity, the existence of comparable performance data, and the

discipline of the rating process. The way to protect banks, non-originating investors and financial stability is not to punish CMBS. Indeed, for EU insurers and other investors, there is a great deal to be said for investing in low risk CRE debt through senior CMBS exposures with those features, rather than through (often higher leverage) whole loans. Broader CRE debt market risks should be addressed by regulators and industry together taking forward the proposals for greater informational transparency, diversification and counter-cyclicality recommended in A Vision for Real Estate Finance in the UK.

***Why don't qualifying securitisation criteria accommodate CMBS?*** Efforts to revitalise simple and transparent securitisation should be recalibrated so that securitised CRE debt is not excluded altogether. The criteria should be designed to incentivise the CRE debt securitisation market to meet appropriate standards for simplicity, transparency and (to the extent reasonably achievable in a fundamentally heterogeneous asset class like CRE) standardisation/comparability. The main problems with the criteria currently proposed are as follows.

**(a)** **Concentration limits** (*Article 243(2)(b) of the proposed CRR amendment regulation; new BCBS STC criterion D16*). The proposed condition that no single exposure/obligor should represent more than 1% of the underlying pool 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 proposed CRR amendment regulation; new BCBS STC criterion D15*). It is proposed that no commercial mortgage loan in the pool must have a risk weight under the Standardised Approach of more than 50%. That is inappropriate, because it would serve simply to exclude CMBS: 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 proposed securitisation regulation; BCBS STC criterion B7*). 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". The BCBS criterion also adopts a relatively flexible approach. 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, regulators must resist a crude approach that rejects any refinancing risk, as that is simply incompatible with the underlying CRE debt market, and fails to recognise how refinancing risk can be managed and mitigated.[2]

**(d)** **Fiduciary standards** (*new BCBS STC criterion D17*). Relevant commercial as well as residential mortgage securitisation markets should be exempted from the proposed requirement that the originator and servicer be the same or affiliated entities. There is a professional and sophisticated third party servicing sector in the CMBS context which works well. While there have been issues around loan servicing in pre-crisis CMBS, this criterion is not the best way to address them – the industry has already responded to the challenge, including through CREFC Europe's Market Principles for Issuing European CMBS 2.0.

[2] We are especially troubled by the EBA's earlier proposal that loans must be fully self-liquidating, and by the European Council's proposed inclusion of 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.