

## **Response to the EBA's Consultation Paper dated 19 March 2015 (EBA/CP/2015/06): Draft EBA Guidelines on limits on exposures to shadow banking entities which carry out banking activities outside a regulated framework under Article 395 para. 2 Regulation (EU) No. 575/2013**

### **Introduction**

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

### **Response to consultation**

We agree that it may be appropriate to impose limits on exposures to entities which carry out bank-like activities that involve maturity transformation, leverage or otherwise presenting shadow banking risks, and operate outside a suitable regulatory framework. However, the approach proposed by the EBA goes much further than that, and cannot be supported. In particular, we believe that the approach adopted in relation to UCITS funds – namely that they should be excluded from scope unless they are MMFs – should also be adopted in relation to AIFs. The EBA's failure to apply similar principles in relation to UCITS funds and AIFs is not explained or justified, and would be both distortive and prejudicial to Europe's financial services industry and the real economy.

In the absence of a definition in the CRR of the terms 'shadow banking entities', 'banking activities' and 'regulated framework', the EBA is right to define shadow banking entities for the purposes of the Guidelines. The decision to include in the definition entities that a) are carrying out credit intermediation activities, defined as bank-like activities involving maturity transformation, liquidity transformation, leverage, credit risk transfer or similar activities; and b) are not within the scope of prudential consolidation nor subject to solo prudential requirements under specified EU legislation (or equivalent third country legal frameworks), in the first instance, is not objectionable. But the EBA's application of those criteria is in our view inconsistent and incorrect.

The proposed capture of a very broad and diverse range of entities that do not, in fact, meet the EBA's own criteria within its "shadow banking" universe matters a great deal once the consequences are taken into account. The EBA proposal on exposures to shadow banking entities goes much further than the existing provisions for managing credit concentration risk in the context of large loans under CRD IV. Those provisions require only the largest loans to be taken into account, whereas the shadow banking proposals would include every loan in calculating the exposure limit (at least under the fallback approach). The 25% limit proposed under the fallback approach itself strikes us as very low, representing just 1/32 of the overall limit for large loans under CRD II and potentially no more than a single exposure under Article 395(1) CRR. If the EBA defines its "shadow banking" universe as broadly as it proposes, the effect could be to place serious constraints on the availability of sensibly priced credit for large parts of the real economy, many of which, as elaborated in the rest of this submission, are not even engaged in credit intermediation of any kind.

In particular, if those real estate AIFs that use leverage cannot obtain appropriately priced finance for their activities, major stakeholders could disappear from the market. We understand that a study of the

interactions between the different kinds of vehicles in the German real estate market shows strong negative correlations, demonstrating the importance of diversity. Measures that would have the effect of reducing that diversity in real estate vehicles could therefore have a material negative impact on the German real estate market as a whole. Given that real estate represents around 20% of Germany's GDP, the impact on the economy as a whole could also be significant. The same logic would apply across the EU.

### ***AIFMD is a sufficiently robust prudential framework***

Probably the most important area where we disagree with the consultation paper approach is its determination of what entities are not subject to "an appropriate and sufficiently robust prudential framework" under the second limb of the definition of shadow banking entities. The European Parliament, European Commission, European Securities Markets Authority and national financial regulators of the EU Members States have developed the Alternative Investment Fund Managers Directive (AIFMD) as a comprehensive regulatory framework for alternative investment fund managers and, by inevitable implication, the funds they manage. It is now fully in effect and covers the vast majority of real estate and other alternative investment funds. We do not understand how the EBA can so casually dismiss the AIFMD as "an appropriate and sufficiently robust prudential framework". The consultation certainly provides no justification.

Indeed, the consultation paper specifically cites the EU UCITS directive (Directive 2009/65/EC) and states that it prescribes a robust set of requirements under which undertakings for collective investment in transferable securities, and their managers, operate. These are noted to include "requirements on the asset manager (initial capital, own funds and internal control requirements) and the managed funds (e.g. limits to leverage and concentration). Therefore, such funds do not pose the same level of risk to institutions in terms of credit and step-in/bail-out risk (e.g. due to reputational, franchise and other risks) as unregulated funds". As a result, UCITS funds (other than MMFs, which are dealt with differently for specific reasons) are specifically excluded from the proposed scope of coverage of the Shadow Banking Guidelines. We agree with both the consultation paper's reasoning and conclusion in this regard. We do not understand why the same approach is not adopted in relation to alternative investment funds and the AIFMD.

UCITS served as the model for AIFMD. Like UCITS funds, real estate and other AIFs within the scope of AIFMD have requirements on the asset manager including initial capital, own funds and internal control and reporting requirements and AIFs are subject to requirements related to leverage. Like UCITS funds, real estate and other AIFs do not pose the same level of risk to institutions in terms of credit and step-in/bail-out risk (e.g. due to reputational, franchise and other risks) as unregulated funds. Like UCITS funds, real estate and other AIFs within the scope of AIFMD (other than MMFs) should be specifically excluded from the proposed scope of coverage of the Shadow Banking Guidelines.

### ***Real estate funds are not part of the credit intermediation process***

The universe of AIFs is very diverse, including among other entities:

- hedge funds, private equity funds, venture capital funds and different kinds of real estate funds;
- closed-ended funds and open-ended funds;
- funds that are highly leveraged, modestly leveraged and unleveraged; and
- funds that invest in real assets, different kinds of operating businesses, and financial instruments, which may (or may not) include loans or other credit exposures.

It is surprising, given the extensive work already carried out by the Financial Stability Board and others in relation to shadow banking, that the EBA has failed to discriminate in any way, proposing instead to shoehorn all AIFs, regardless of their characteristics, into its shadow banking definition. No doubt some funds engage in maturity and liquidity transformation and are outside the traditional banking sector – and for some such AIFs there may be a case (as in the case of MMFs subject to UCITS) for arguing that the AIFMD does not, in all the circumstances, constitute an appropriate regulatory framework. However, the EBA has not conducted any such analysis, has failed to identify AIFs that present particular shadow banking risk characteristics, and has failed to explain why, for any such AIFs, the AIFMD is not an adequate regulatory framework.

### ***Real estate equity funds***

The FSB's Global Shadow Banking Monitoring Report 2014 has a section specifically discussing real estate funds. It notes that most real estate funds invest in and own physical properties so that their revenues are derived directly from rental income. (We will discuss real estate debt funds separately below.)

The FSB concludes, very easily and naturally, that real estate funds that invest in and own physical properties are “typically not part of the credit intermediation process, as they neither lend directly to other financial entities nor do they hold fixed income products in any significant way in their investment portfolio”. That description applies to many real estate AIFs. They carry on some or all of the construction, acquisition, maintenance and management of land and buildings that are rented out to businesses or other users. They are not part of the credit intermediation process and therefore do not meet even the first part of the first limb of the EBA's definition of “shadow banking entities”.

The EBA should reconsider its view, or at the very least set out its reasoning and identify the principles whose application to funds should determine which AIFs, in particular, should be treated as shadow banking entities. The EBA has only explained its proposed inclusion of MMFs (regarding which we express no opinion as MMFs fall outside our area of expertise). The EBA has adopted contradictory approaches to UCITS funds and AIFs without adequate explanation. Such an approach will create arbitrary differences between EU definitions and those emerging at the global level, and will not serve the EU's economy or financial system.

### ***Real estate debt funds***

Real estate debt funds warrant separate discussion they can plainly be considered part of the credit intermediation process. The question is whether they meet the rest of the EBA's definition:

- do their activities involve “maturity transformation, liquidity transformation, leverage, credit risk transfer or similar activities”?, and
- are they within the scope of appropriate prudential regulatory requirements?

Most European real estate debt funds are closed-ended, and use either no, or modest levels, of leverage themselves. Their similarity to banks begins and ends with their provision of credit to the real economy. They do not carry out maturity or liquidity transformation, they are not exposed to run risks, banking system interconnectedness issues do not arise, and they could, of course, be allowed to fail. Furthermore, the AIFMD provides a robust and adequate regulatory framework for them which limits and allows monitoring of such risks as they might pose. Unfortunately, rather than reach the conclusion that such real estate debt funds should therefore fall outside its own proposed definition, the EBA has failed even to analyse them, simply sweeping them into scope on the basis that they are AIF. This is not the kind of regulation the EU needs.

Real estate debt funds have in recent years been playing an essential role in helping Europe's banks repair their balance sheets, addressing the pre-crisis legacy of over-leveraged real estate across Europe. At the

same time, they are providing new, alternative sources of credit for real estate businesses and access to the illiquidity premium offered by real estate debt to investors seeking yield in a low interest rate world. We do not see the case for lumping them with entities characterised by shadow banking risk factors.

We do of course acknowledge that there may be real estate debt funds (and indeed other kinds of AIFs) which are characterised by shadow banking risk factors that justify their classification as shadow banking entities, notwithstanding the regulatory framework provided by the AIFMD. But if the EBA is to regulate intelligently, it must first analyse and understand this market and apply consistent, appropriate principles to determine the scope of its intervention.

### ***AIFs not managed by an AIFM authorised under the AIFMD***

A further, narrower, point is that the EBA proposes including not merely "all AIFs managed by an AIFM that is authorised under the AIFMD", but "all AIFs". The AIF definition is a very broad one (and in fact a somewhat uncertain one on the margins), with no territorial limitations and no minimum size requirement. The AIFMD is only relevant to those with sufficient territorial nexus to the EU, and authorisation of AIFMs is only required where a minimum size of AIF managed by the AIFMD is exceeded. Accordingly, we comment on two specific categories of AIF that are not subject to the full AIFMD regime.

- Sub-threshold AIFMs and the correspondingly small AIFs they manage are specifically excluded from the scope of coverage of the AIFMD. Their exclusion is justified by the modest level of risk they pose and the disproportionate burden that full AIFMD compliance would represent for such small entities. The same logic dictates that they should also be excluded from the scope of coverage of the EBA's Shadow Banking Guidelines, unless there are clear reasons for including them. The EBA has not put forward any justification including them.
- AIFs whose AIFM falls outside the scope of the AIFMD for territorial reasons should in our view also fall outside the scope of the EBA's Shadow Banking Guidelines. Given that the connection of such AIFs to the EU is insufficient to justify regulation under the AIFMD, the EBA would need to make a clear case for defining them as shadow banking entities. The EBA has not done that.

### ***International consistency***

As a final point, the EU should also be very wary of taking an approach that so conspicuously diverges from the far more reasoned and evidence-based approach taken by the FSB at the global level. While the basic definition is put forward seems to us to be broadly in line with the FSB's approach, the way the EBA proposes to interpret and apply its definition most certainly is not.

We would be pleased to help the EBA better understand the real estate funds and the real estate debt funds that form part of the AIF universe so that it can develop a more appropriate proposal than that contained in the Consultation Paper.

Yours faithfully



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