

A Vision for Real Estate Finance in the UK

Recommendations for reducing the risk of damage
to the financial system from the next commercial
real estate market crash.

A report by a cross-industry real estate
finance group.

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Investment Property Forum
New Broad Street House
35 New Broad Street
London
EC2M 1NH

Tel 020 7194 7920
Email ipfoffice@ipf.org.uk
Web www.ipf.org.uk

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Foreword

Financial stability is important – far too important to be left to a process that pitches well-intentioned, inherently imperfectly informed regulators against well-informed, understandably regulation-resistant lenders. Much better is an approach involving experienced professionals from across the market spectrum, each stepping aside from the interests of their organisations and resolved to make their best recommendations for a market structure which both protects financial stability and supports economic growth. This is the approach adopted by a group of people drawn from a cross-section of the real estate industry – the Real Estate Finance Group – in making these recommendations on the UK's commercial real estate lending market.

'A Vision for Real Estate Finance in the UK' was conceived in the summer of 2012, while preparing the Property Industry Alliance's update for the Bank of England, presented at the Bank of England Commercial Property Forum. Confounded by the lack of a cohesive strategy underlying the numerous regulatory proposals, we suggested that the industry should develop a vision for the commercial real estate lending market, against which regulatory proposals affecting it could be judged.

The Group¹ first met in January 2013 and, following many hours of discussion, published its draft recommendations² in October. The Group has since received considered and some very detailed responses from across the sector, which have helped shape the final recommendations contained in this final Report. Our recommendations fall into three categories:

- (a) Information, analysis and expertise;
- (b) Incentives; and
- (c) A market structured for stability.

A summary of the recommendations is on the next page.

While it is important to focus on each recommendation in turn, much of their value lies in the interrelationships between them – together they form a powerful suite of tools, which we consider would deliver the objectives of the vision.

A vision without action is useless. The Group having used the passion, knowledge and experience of its members, as well as all those who have contributed to the vision through dialogue with members of the Group, to produce these recommendations, must now pass responsibility for action to the regulators, lenders and other market participants with the power to implement them. The Group sincerely hopes they will take this opportunity, in the interests of financial stability and the economy, and remains prepared to assist with implementation as best it can.

Finally, I thank everyone involved for the contribution they have made to the project. In particular, the Review Group (whose lengthy debates I have enjoyed), the Support Group and those involved with work streams, as well as the organisations that have made them available to the project, the IPF who provided financial sponsorship (free of the reins of editorial control), Oliver Burrows (whose technical guidance saved us so much time and effort), Peter Cosmetatos (who took on the bulk of the burden of drafting this Report), Andy Haldane (whose encouragement has sustained the Group) and Grosvenor for allowing me the time to chair the Group.

Nicholas Scarles (Chairman)

¹ The membership of the Group is shown in Appendix 3 (The Real Estate Finance Group).

² 'A Vision for Real Estate Finance in the UK. Draft recommendations by a cross-industry real estate finance group. An industry discussion.' See: www.ipf.org.uk

Key recommendations

Information, analysis and expertise

1. Loan database: All lenders in the UK commercial real estate (CRE) market, regardless of type or location, should be required to collect and submit to a centralised database specified information about each UK CRE loan and its collateral, immediately upon making the loan and periodically throughout its life. The regulator should have full access in real time not only to the data, but also to individual lender and overall market risk analyses conducted on the basis of the data. There should also be controlled public access to the database.

2. Expertise and insight for the regulator: The regulator should have access to expert interpretation and analysis of market information, particularly to give it insight into where in the cycle the overall market and individual market segments are likely to be at any particular moment. Expertise and insight from market participants and external experts should supplement and complement a well-resourced pool of CRE finance expertise within the regulator.

3. CRE finance qualifications: Key members of CRE lending teams and credit functions with responsibility for UK CRE lending, regardless of type of institution, should have an appropriately accredited CRE lender qualification, maintained through continuing professional education.

Incentives

4. Use of long-term value measures for risk management: For CRE lenders subject to regulatory capital rules, loan-to-value (LTV) based capital requirements should be linked to a long-term measure of collateral value that is insensitive to the investment cycle.

5. Better risk differentiation in regulatory capital requirements: The basis for regulatory capital requirements should more accurately reflect the actual level of risk arising from CRE loans, with greater differentiation of capital requirements between loans with different risks. Very low-risk CRE lending (even if unrated) should be recognised as such for banks, including through the terms on which such loans may be used as collateral at the Bank of England.

A market structured for stability

6. Encouraging diversity: The regulator's function should reflect the important role that can be played in promoting financial system resilience and stability by diversity of lender response (principally through diversity of lender types and lender strategies, and with a focus on the role secondary markets can play). Where possible, regulatory action should have regard to levels of diversity and seek to reduce barriers to entry, particularly for new or under-represented types of lender.

7. Regulatory governors, not switches, operating consistently across the cycle: Regulators should use regulatory governors (including the application of sectoral and counter-cyclical capital buffers) that increasingly restrain regulated lenders as the CRE market rises above its full cycle average, irrespective of views about whether a CRE market crash is anticipated or considered unlikely. An explanation should be required where the regulator wishes to override that framework.

Structure of this Report

The main body of this Report begins with an Overview that explores the role and importance of property and property debt in the economy and for financial stability, outlines the objectives, scope and approach of the report, describes the envisaged market and its features, and explains its approach to implementation and transitional issues. The Report then presents the Group's seven key recommendations in three sections, each prefaced by an introductory discussion:

- Information, analysis and expertise, introducing recommendations for:
 - a loan database,
 - expertise and insight for the regulator including through an expert advisory group, and
 - CRE finance qualifications;
- Incentives, introducing recommendations relating to regulatory capital and specifically for:
 - the targeted use of a long-term value concept for risk management, and
 - better risk differentiation in regulatory capital rules;
- A market structured for stability, introducing recommendations for:
 - encouraging diversity in CRE lending, and
 - a regulatory framework, based on governors rather than switches, that is consistent across the cycle.³

Some further detail is provided in the Appendices.

It is intended that it should be easy to understand each section and its related recommendations independently, but it is an essential characteristic of the vision that its elements are closely connected and mutually reinforcing: they are a package that is more than the sum of its parts. So while the Report is broken down into sections, we have used footnotes to draw attention to the connections between the recommendations, as well as to provide additional detail.

³ Governors operate gradually and increasingly on an automated, 'pre-programmed' basis. Switches, by contrast, are on/off measures, applied in an ungraduated way, often as a result of un-programmed, presumptively ad hoc judgments responding to events.

1. Overview

1.1 Setting the scene

The importance of this vision can best be understood through an appreciation of the role played by commercial real estate (CRE) in the wider economy and in particular its contribution to economic growth and prosperity, as well as its potential to cause or exacerbate financial crises.

Property in the economy: CRE is a central part of our built environment, representing at least 25% of the UK capital stock⁴ and provides employment for around 800,000 people.⁵ It is where we work, shop and relax, and it is a vital enabler of economic activity capable of supporting or constraining employment and growth. A large and healthy CRE investment market provides incalculable value to the economy by allowing businesses to rent premises flexibly according to their changing needs. Around two thirds of the UK's CRE is leased out to occupiers by CRE investors in this way, enabling occupiers to focus on their business and optimise their use of capital.

The property cycle: CRE is fundamentally long-term, illiquid and capital intensive at two levels:

- 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 or shares – typically weeks or months rather than minutes. 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 bricks and mortar cannot be expected to match 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 increased 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.

Equity and debt: For a variety of reasons,⁶ many CRE investors use debt, as well as equity, to fund their CRE investment activities. That means that CRE lenders (including banks) can also be said to invest in CRE. Unlike equity investors, however, debt investors cannot make super-profits on some transactions to compensate for losses on others, because their upside is limited to their finance charge.

For that reason, lending to CRE businesses (like lending generally) should be a less volatile and risky business than equity investment, particularly for banks and other systemically important financial institutions (SIFIs). The supply of CRE debt should respond to demand from those with specialist expertise in CRE who are willing to take the risk of investing the equity capital at their disposal. CRE risk taken on by SIFIs should be properly understood and priced by those institutions, and reflected in adequate equity reserves in line with appropriate regulatory capital rules. Problems arise if that does not happen.

⁴ The 25% figure is derived from Office of National Statistics (ONS) data. The true figure may be much higher, because ONS capital stock figures are based on depreciated historic cost rather than market value. More than for other components of the UK's capital stock, CRE cost and value differ markedly, largely due to the supply restrictions imposed by planning policy.

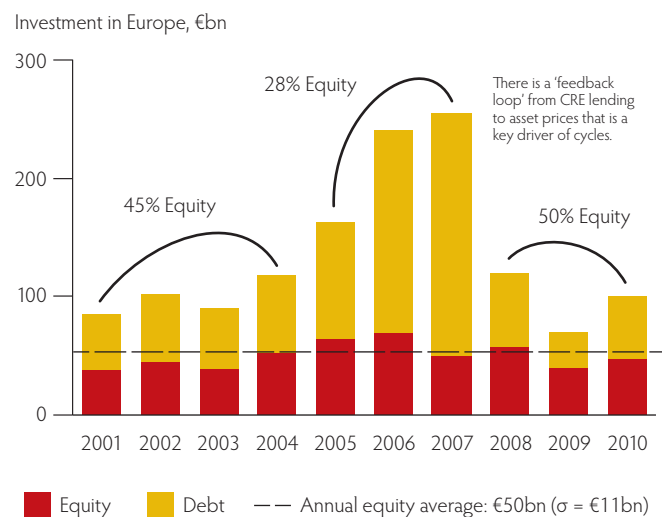
⁵ *The Role of Commercial Property in the UK Economy*, published by the IPF Research Programme, 2013.

⁶ Discussed in Appendix 1 (CRE and CRE finance in the UK).

Three features of CRE debt are crucial to its role in the CRE cycle:

- The speed with which debt capital can flow into or out of CRE dramatically amplifies the CRE cycle. Figure 1 shows how volatile CRE debt flows were in the cycle that culminated in the global financial crisis (GFC). By comparison, the flow of CRE equity investment was relatively stable during the same period. Both the rapid growth in CRE prices in the boom and their steep fall in the bust were largely driven by the behaviour of CRE lenders, rather than by equity flows into CRE.
- The majority of lending is advanced during the exuberant phase of the cycle. The optimistic mind-set of the boom informs how market participants value CRE cash flows and perceive the risk of loss, and can even affect the related regulatory capital requirements.⁷ Moreover, as the cycle progresses, the use of traditional LTV measures will tend to drive overall lending volumes higher. With insufficient capital built up during the boom, lenders can find themselves very exposed after a crash, with many outstanding loans no longer covered by the value of the property on which they are secured. As the GFC showed, the consequences for the financial system, the taxpayer and the economy as a whole can be very damaging when SIFIs find themselves in that position.
- The competitive environment of the boom favours borrowers over lenders in terms of risk-adjusted returns. In theory, both borrowers and lenders take more risk as loan-to-value (LTV) ratios rise and loan margins fall. However, borrowers will have progressively less equity at risk as the market heats up, and are therefore the residual beneficiaries of any cycle-driven mispricing of CRE debt. Such mispricing occurs because competition encourages lenders to reduce the margins they charge, even as rising values increase both their risk of loss and the amount they have at risk. It seems likely that cycle-related pressures increasingly tempt lenders to price loans by reference to their cost of funds (which will be lower late in the financial cycle), rather than on the basis of relevant risk characteristics. This state of affairs suits the more entrepreneurial and risk-taking parts of the property industry, but is unhelpful for financial stability.

Figure 1: Drivers of the CRE cycle



Sources: CBRE; Property Data; KTI; De Montfort University

CRE debt and financial stability: The experience of the last few years fits into a long tradition of financial crises linked to the property cycle. Figure 2 shows that the UK CRE market has experienced five distinct boom-bust cycles in the last century, characterised by average peak-to-trough price falls of 26%.⁸

The impact on the health of the banking system was very clear in the GFC, as the Bank of England reported in its first Quarterly Bulletin (see footnote 123) in 2013:

“A Financial Services Authority (FSA) survey in 2011 suggested that around a third of the outstanding stock of commercial property loans were in some form of forbearance, where the lender had waived loan covenants, such as LTV requirements, or relaxed interest and repayment requirements, to make it easier for borrowers to service the debt.”

⁷ As discussed in the section on Institutional incentives, regulatory capital frameworks generally either pro-cyclically encouraged banks to move up the risk curve (where capital requirements were not risk-sensitive), or were vulnerable to optimistic interpretation (where capital requirements depended on models or judgment).

⁸ See www.bankofengland.co.uk/publications/Documents/speeches/2013/speech701.pdf. The amplitude of the property cycle is perhaps three times greater than that of the business cycle.

“Moreover, there has been a very wide range of loan performance across the large UK banks that are covered in the FSA survey. While the median cumulative write-off rate across that group was 2% from 2008 to 2012, the worst-performing bank in the peer group wrote off nearly 20% of its loans (see Figure 3).”

“The quality of banks’ remaining loans is still in some doubt. Another survey by the FSA found that in 2011, for the median bank, 14% of the total amount of CRE debt was accounted for by loans that exceeded the value of the property against which they were secured (that is, loans that were in negative equity); for the worst performer that figure rose to over 40%. And a separate survey found that in 2012, while the median bank had just over 20% of loans in some form of forbearance, for the poorest performer on this metric, around half of the outstanding stock of CRE loans was in some form of forbearance. Many of these loans are unlikely to be refinable in current market conditions.”

The relationship between the CRE cycle, debt and financial stability is the rationale for this Report’s specific focus on CRE finance and its regulatory regime.

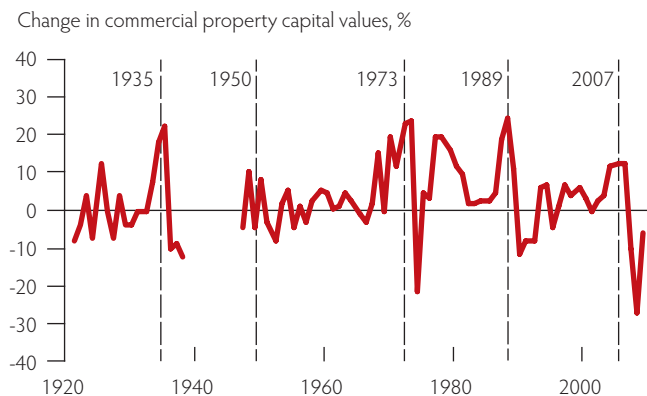
CRE lending not as simple as it might seem:

There is an illusory simplicity to CRE lending: assessing and pricing the risk of a secured loan against an income producing physical asset⁹ is surely a more straightforward matter than lending to most other kinds of business. But CRE lending is a varied universe and can be anything from very risky to very safe. Over many cycles in many countries, neither banks nor their regulators have found effective ways of systematically assessing and managing CRE lending risk. Instead, they go with the cycle; underestimating risk and flooding the CRE market with debt in a boom, and overestimating risk and starving the CRE market of credit after a crash.

Improving stability: Stopping the CRE cycle is neither possible nor necessary to protect financial stability. However, the financial system’s ability to weather future CRE booms and busts can be strengthened by loosening the link between the CRE cycle and the two different cycles that feed it:

- The pro-cyclical behaviour of banks and other lenders which feed the boom with loose lending, before exaggerating the bust by starving investors of credit; and

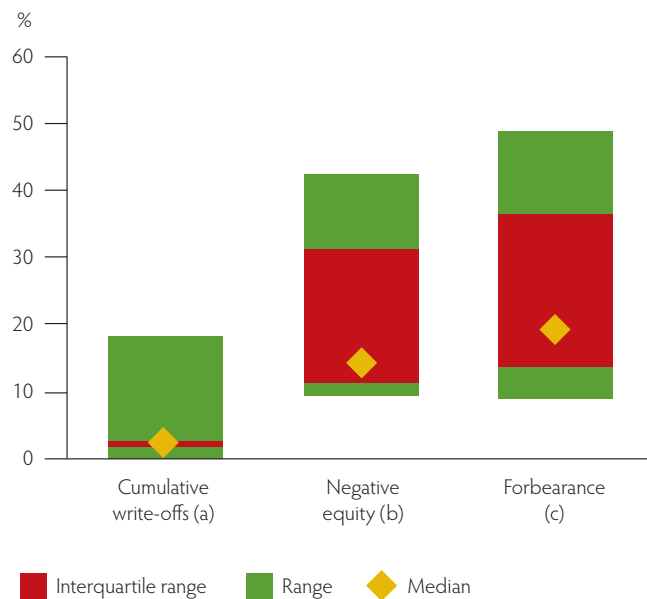
Figure 2: UK CRE market boom-bust cycles



Sources: Scott (1996), IPD; Bank of England.

Note: The vertical dotted lines indicate the discernable booms and busts. The attached labels indicate peak years.

Figure 3: Losses on, and non-performing, CRE lending for major UK banks



Sources: FSA surveys and Bank of England

Notes: (a) Write-offs from the beginning of 2008 to September 2012, expressed as a share of the stock of CRE loans at end-2007. (b) Share of the stock of CRE loans in negative equity as at September 2011. (c) Share of the stock of CRE loans in forbearance in 2012 where available, otherwise 2011.

⁹ Lending against construction/development projects is a more obviously complex and specialised business.

- The pro-cyclical behaviour of regulators who tend to grow too relaxed about risk when markets are overheating and risk is objectively greatest, and become excessively risk averse after a crash when credit is most needed to support investment and risk is objectively lower.¹⁰

Improved stability also good for property and the economy: Building greater stability and counter-cyclical mechanisms into the financial and regulatory systems to decouple lending and regulatory cycles from the CRE cycle should also help the CRE sector and the wider economy. Rather than exacerbating the cyclical peaks and troughs through alternating excess liquidity and credit drought, lending institutions and their regulatory framework could instead provide a more consistent and sustainable flow of credit to CRE across the cycle. Furthermore, as improved stability reduces risk for lenders and borrowers, their required returns should fall, reducing the cost of both debt and equity capital for CRE investors and their customers and increasing investment to support wider economic growth.

1.2 Scope and approach

Objective: The central objective of this Report is to produce a vision for the CRE finance market in the UK which would ensure an attractive, efficient and stable market, in the timeframe of the next cycle.

Scope: While aspects of the Report may have broader application, its focus is exclusively on CRE finance. References to **CRE debt, credit or finance** in the Report are essentially to the type of activity covered by the banking regulatory concept of specialised lending exposures to income-producing real estate (**IPRE**).¹¹ However, while that concept is taken from banking regulation, this Report is not limited to that source of CRE debt – the Report is concerned with the whole CRE finance market. Lending against CRE construction/development projects falls within the scope of the Report if the asset being created is intended for sale or to be held as an income-producing asset (i.e. investment property, rather than owned by its occupier). By contrast, ordinary business lending is outside the scope of the Report, even where that lending is made to a real estate business or is secured on real estate.¹²

A through-the-cycle approach: This Report does not seek to answer questions relevant only to specific points in the cycle. Rather, the Report seeks to step outside the cycle and identify the lessons we can learn, particularly from the experience of the last few years in the UK and elsewhere, for the future, and to envision a better functioning and better regulated CRE finance market. That vision is intended to be capable of being delivered over the next several years, so that the UK's financial system is better placed to weather the impact of the next CRE crash and provide a sustainable flow of credit to the CRE sector across the cycle.

Causes and correlations: The Report does not seek to explore or address the causes of CRE booms and busts. Historically, the cycle repeats itself, but the particular causes of each boom or bust have varied. Where recommendations require an assessment to be made of the market's current position in the cycle, the focus is on identifying indicators that are reliably correlated with different phases of the cycle and using them to apply counter-cyclical mechanisms within the regulatory framework for CRE finance.

1.3 The envisioned market and its features

The Group's vision is for a UK CRE finance market and regulatory regime which:

- Protects SIFIs and the financial system from the CRE cycle, in particular by ensuring that such financial institutions hold sufficient capital to withstand a market crash;

¹⁰ As Andrew Haldane, Executive Director, Financial Stability, Bank of England, put it in a speech at the American Economic Association Annual Meeting on 3 January 2014, the 'time-consistency dilemma' facing macro-prudential regulators, "manifests as a desire to loosen regulation to support today's growth when tightening to counter tomorrow's crisis would be more appropriate".

¹¹ See <http://fshandbook.info/FS/html/handbook/BIPRU/4/5>.

¹² That is not to ignore the way secured lending to non-CRE businesses increases lenders' overall exposure to the CRE market and the CRE cycle (see Appendix 1 (CRE and CRE finance in the UK)).

SECTION 1: OVERVIEW

- Reduces pro-cyclical tendencies, by moderating the flow of credit to the CRE sector as the cycle moves towards its peak and ensuring financial institutions are positioned to support CRE investment after a crash, including in regional markets and for smaller CRE borrowers and assets; and
- Promotes the contribution of the CRE sector to the economy by providing a sustainable flow of CRE debt funding across the cycle, including in regional markets and for smaller CRE borrowers and assets.

The Group considers that a combination of market forces and effective regulation is required to deliver that vision. Effective regulation must be informed, focused and proportionate, and avoid unjustifiably distorting the market. The Group feels that the following features should characterise the envisioned market and regulatory environment:

- Participants, potential participants and regulators are **informed** by good quality, granular, timely data, and by expert knowledge, analysis and advice;
- The CRE market and regulatory structure actively **encourage industry self-management**, with market participants developing and promoting good practices, thereby reducing the need for regulatory intervention;
- The regulatory approach is instinctively **supervisory** and encouraging before it is interventionist. Where the Report recommends regulatory change, the intention is to improve the quality and effectiveness of regulation, not to increase or decrease the overall amount of regulation;
- The regulatory framework adopts largely **automated (and so predictable) 'governor'-based interventions** – operating incrementally as the CRE market moves through the cycle – to influence market behaviours, rather than blunt instruments and 'on/off' switches (likely to be reactive interventions based on regulatory judgments regarding the progression of the CRE cycle);
- Regulatory measures and incentives are **fundamentally counter-cyclical**; and
- Regulators are **adequately resourced and supported** (by Government and the industry).

The recommendations discussed in the rest of this Report seek to translate these features into concrete proposals.

1.4 Implementation and transition

Many of the recommendations in this Report involve a significant move from where we are today. Implementation and transition will not always be straightforward, and there will be choices to be made as to the best approach to take. Trade-offs will be inevitable, for example between speed and disruption, comprehensiveness and cost, simplicity and fairness. In some cases, implementation should be a staged process as market or regulatory practice evolves towards the recommendations over time.

In developing its recommendations, the Group considered whether any of them were likely to involve insurmountable problems of implementation or transition, and concluded that they should not. Having reached that conclusion, the Group chose to concentrate in this Report on describing the outcomes it believes we should be trying to achieve, and explaining how and why its recommendations would help achieve them. Where implementation choices and challenges are particularly obvious the Report discusses them, but deliberately avoids making more than limited reference to matters of implementation and transition.

Having said that, the Group is under no illusions as to the challenges that implementation and transition may pose. As a broad consensus emerges across industry participants and the regulator about the desired destination, the regulator, industry participants and relevant industry and professional bodies will be expected to play their part in translating the vision into reality. The Group and its members are prepared to continue to contribute in whatever way is most useful.

2: Recommendations

2.1 Information, analysis and expertise

Good quality information, and the ability to understand it, is fundamentally important for a well-functioning market and effective regulation and is the focus of the first three recommendations of this Report.

Information: It is essential to have comprehensive, current, granular data as the foundation on which to build effective risk management and regulatory frameworks. Such data exist to varying degrees for CRE,¹³ and for both residential property¹⁴ and residential mortgage lending.¹⁵ However, the only data available for the CRE finance market is collected (whether by Government or regulatory authorities or by the industry¹⁶) with a significant time lag, only at an aggregated level, and without clarity and consistency as to the precise coverage universe and classifications used. Granular, timely information is critical infrastructure for a meaningful understanding of performance and risk in the complex and heterogeneous CRE market. One of the lessons of the last few years has been the realisation that neither market participants nor the regulator had access to such information – either to help them understand and manage the boom, or to help them assess possible responses to the bust.

Regulatory access to expertise: It is also important that the regulator should have access to expert interpretation and analysis of market information, particularly information and insight offering reliable indications as to approximately where in the cycle the market may be at any particular moment. Some of that expertise should be available within the regulator; but external expert advice – both from current market participants and from others with relevant expertise – is also necessary to enable regulators to be fully effective.

Industry expertise: Market participants in key CRE finance roles need to have the necessary skills and experience to make commercial decisions which, depending on their particular role, take individual loan, portfolio or market level risk appropriately into account. There are currently no CRE finance qualifications that are widely recognised and used in the market through which market participants might demonstrably acquire and maintain relevant expertise. It is not suggested that educational qualifications are a substitute for experience, or common sense. However, with 20 years typically separating major CRE market crashes, appropriate training can complement the experience of past crashes that only longer-standing staff in lending institutions (and the regulator) will have.

¹³ Notably in the form of indices and data collected and managed by IPD, which predominantly cover better quality, institutionally owned investment property (see www.ipd.com).

¹⁴ For example in the form of data published by HM Land Registry.

¹⁵ The Council of Mortgage Lenders produces statistics on residential mortgages (see www.cml.org.uk).

¹⁶ The most notable industry source is the twice-yearly **UK Commercial Property Lending Report** produced by De Montfort University since 1997 (see <http://www.dmu.ac.uk/about-dmu/schools-and-departments/leicester-business-school/the-uk-commercial-property-lending-report.aspx>).

Recommendation 1 (Loan database)

All lenders in the UK CRE market, regardless of type or location, should be required to collect and submit to a centralised database specified information about each UK CRE loan and its collateral, immediately upon making the loan and periodically throughout its life. The regulator should have full access in real time not only to the data, but also to individual lender and overall market risk analyses conducted on the basis of the data. There should also be controlled public access to the database.

AIMS

To provide the essential informational infrastructure required for better risk monitoring and management by both lenders and regulators, by:

- Providing lenders and regulators with timely information about the CRE debt market and activity and risk at the portfolio and market level.
- Allowing real-time risk analysis and stress-testing of CRE lending portfolios to be conducted by reference to up-to-date, good quality, relevant and comparable data.
- Allowing analysts, academics and others to undertake analysis and provide insights, including comment on underwriting standards and warnings of overheating, to lenders, borrowers, investors and regulators.
- Supporting a cost-effective and consistent approach to loan valuation and the long-term valuation of collateral¹⁷ by providing a comprehensive common information source.
- Facilitating better calibration of regulated lenders' capital requirements, allowing a better balance to be struck between securing the economic benefits of sustainable credit to an important enabling sector of the UK economy and protecting financial stability.

To promote a more diverse and resilient CRE debt market, both in terms of primary lending and in terms of a liquid secondary market for non-originating lenders, and thereby a more sustainable flow of appropriately priced credit to CRE businesses across the cycle, by:

- Improving transparency and lowering barriers to entry for new lenders, thereby facilitating the emergence of a more diverse CRE finance market.¹⁸
- Delivering overall market information about matters such as lending terms, market composition, concentration risk, flow and stock of debt, average loan age and maturity profiles, and classification by geography, sector or other criteria relating to the collateral.
- Allowing benchmarking of individual loans and loan portfolios and analysis of performance against particular loan and collateral characteristics, and supporting (in the context of CRE lending) consistent interrogation and analysis of the way regulated lenders have determined their risk-weighted assets.
- Enabling the development of commonly accepted standards and practices in loan origination and making informed investment in CRE debt more accessible for non-originating lenders.

¹⁷ As contemplated by Recommendation 4.

¹⁸ As contemplated by Recommendation 6.

DISCUSSION

Types of lender covered: The scope of the database should not be limited to banks or regulated UK lenders. The activities of other market participants also aid understanding, and affect the behaviour, of the market and the risk to which regulated and other lenders are exposed, so they should also be monitored.¹⁹ If, as we hope, the market becomes more diverse, the influence of other market participants will become ever more important. Any concerns about the enforceability of the data provision requirement against overseas and unregulated lenders might be overcome by, for example, requiring a data submission receipt to be shown in order to register a charge or enforce security.²⁰

Types of loan covered – size: The scope of the database should not be limited to larger loans. Once the data collection and reporting systems are in place at the major lenders and loan servicers – the organisations most likely to have large books of small loans on which to report – the incremental cost of covering small loans should be relatively modest. Furthermore, smaller scale credit, which is particularly relevant for SMEs and in the regions, matters to the economy and presents particular challenges in terms of transparency, market composition, volatility of supply and risk management. The aim should therefore be for the database to be universal, even if some tiering of reporting requirements or phasing of implementation are felt appropriate.

Types of loan covered – borrower: The perimeter of CRE lending for the purposes of the loan database should be drawn around the banking regulatory concept of IPRE.²¹ Essentially, therefore, a loan should be included if it is secured on a single UK CRE asset or portfolio of such assets and the payment of interest and repayment of principal depend on the performance of the relevant asset or portfolio (in terms of income generated and actual or potential sale proceeds). A number of boundary issues are briefly noted below and might merit further consideration as this Recommendation moves towards implementation:

- It seems reasonable and practical to exclude unsecured loans, even if the borrower is a real estate business.
- Ordinary commercial loans benefiting from security over business premises should also be excluded. Generally, such loans will fundamentally depend on the covenant strength and cash flows of the operating business, and the security may be no more than a helpful credit enhancement. However, there may be cases where the lending decision is strongly influenced by the real estate security, with the lender devoting less attention to the strength of the borrower's business, which may be difficult to analyse confidently. This distinction is embedded in existing bank capital rules and presents arbitrage risk because different regulatory capital rules apply to IPRE and commercial lending. It is unlikely to be worth trying to draw a different boundary.
- Loans secured on construction/development property have particular features that may give rise to additional complexity in designing data reporting templates.²² Given the role development finance has played in some CRE market crashes, they should clearly be included when the development is for investment or sale as opposed to owner-occupation.²³

¹⁹ Indeed, the risk analysis made possible by the database would allow the regulator more effectively to monitor whether the coverage universe of regulatory capital requirements is appropriate. As far as CRE debt is concerned, this should reduce the danger that regulation of regulated lenders drives systemic risk build-up to parts of the financial system that are outside the regulator's field of vision.

²⁰ The information submission requirement is a two-edged sword for smaller lenders and new entrants: on the one hand, the greater transparency it brings should be a big positive; on the other, a certain investment will be needed to make the collection and submission of data possible. The Group believes that, even viewing these impacts in isolation, the benefits outweigh the costs.

²¹ See discussion in Section 1.2 (Scope and approach) to this Report.

²² Development assets also present significant challenges in the context of Recommendation 4. They may fall outside the scope of existing data reporting systems such as those linked to commercial mortgage backed securities (CMBS), which only generally relate to stabilised assets that are already income-producing.

²³ The Group believes this to be in line with the existing IPRE concept – see for example the discussion of that concept in an October 2001 Working Paper of the Basel Committee on Banking Supervision on the Internal Ratings-Based Approach to Specialised Lending Exposures.

SECTION 2: RECOMMENDATIONS

Cost implications: This Recommendation does not seek to require the collection of information for the sake of it – both financial stability and market efficiency should benefit from the transparency and insight it aims to bring. It is anticipated that the loan data templates for initial and ongoing information would concentrate on information that is useful for portfolio and market risk analysis and stress-testing, such as lending organisations would find useful for their own risk management purposes. For well-managed lending institutions, the additional burden of data collection should not be great (and the cost/benefit analysis where significant investment is required should be positive). Two issues in particular will affect how easy lenders find it to comply with the proposed data requirements:

- While it is envisaged that the data collection and submission requirement would fall on those originating and servicing loans, much of the data would have to come from borrowers. It would therefore be important for borrowers to understand the intended benefits of compliance, namely a more stable, efficient, diverse, and transparent market with greater liquidity, lower risk and better pricing. As those benefits may be indirect and remote, appropriate incentives to ensure compliance by borrowers will be required. Borrower obligations in loan documentation should be brought into line with this Recommendation.
- Some lenders may face significant costs in putting the technical infrastructure in place for collecting and submitting this information. In effect, this is the result of long-term under-investment in information management systems, which needs urgently to be addressed in any event. Taking forward this Recommendation could encourage that new wave of investment, without which the requisite step-change in the quality of risk management will not be possible.

Ultimately, however, the overall cost of implementing this Recommendation should be seen in the context of the Vision as a whole, and most importantly of Recommendation 4 (Use of long-term value measures for risk management). The property level data captured by the database should become a key, low cost input for better and more cost effective valuation (both long-term and market). That synergy is an important example of how lenders, as well as others, can benefit from the standardised, consistent and comparable data collection that this Recommendation requires. Once the data collection and submission system is in place, and having regard to its likely beneficial impact on the cost of valuations, the marginal cost of maintaining the data collection and submission system would be modest. Overall, the Group considers that the benefits, in terms of market transparency and an improved ability to assess, analyse and manage CRE lending risk (both for market participants and for financial stability), would far outweigh the costs of implementing this Recommendation.

Transition: Ideally, the data requirement would apply to all existing loans as well as new loans, and a valuable database would most quickly be constructed if accurate historic data could also be added at the outset. Inevitably, there is a trade-off between the benefits of speed on the one hand and higher near-term costs on the other, and there is also a risk that data relating to historic and even current loans may not be accurate, or even available.

- UK banks typically carry out an annual review of all their loan positions. If possible, that process should be used to populate the new database with a high proportion of the stock of outstanding UK CRE loans.
- To the extent that is not possible, a staged approach to implementation could achieve meaningful market coverage relatively quickly. For example, even if the data requirement is initially only imposed in respect of new loans as they are made, with existing loans only brought into scope when they are extended or otherwise amended, significant coverage would be achieved within a few years. One might then seek to capture historic outstanding loans over a longer time frame. Expired historic loans should be subject to voluntary capture only.²⁴

²⁴ By analogy, see the way the European Market Infrastructure Regulation (EMIR) approaches the provision of information about new, existing and outstanding, and historic derivatives.

Information template: It is beyond the scope of this Report to explore the data fields that should be contained in the reporting template. The Group would expect the focus to be principally on objectively measurable quantitative data relating to the loan and the real estate collateral, although some qualitative information may also be included. It is also important to ensure that assurance and validation of data submitted can be carried out in a reasonably efficient and reliable way. As mentioned below, there are a number of commercial, industry and official initiatives in this area that might be adopted or adapted or from which we might be able to learn.

Frequency of information provision: The aim is for as much of the database as possible to be accurate in real time. However, while the prompt capture of data at the inception of a loan should not present particular difficulties, the extensiveness and frequency of subsequent reporting needs to be pragmatic and proportionate. Loan and collateral characteristics do not generally change over the very short term, and requiring lenders (and, by extension, borrowers) to report largely unchanged data frequently would deliver little benefit at significant cost. A natural starting point may be to link reporting to the time at which lenders receive information from borrowers.²⁵ In any event, periodic updates should be required no less frequently than annually.

Confidentiality: Commercial confidentiality and data protection issues mean that certain data should not be publicly accessible in identifiable form. A balance must be struck between the transparency and other benefits of public access, confidentiality and the individual lender's desire to retain the commercial benefit of the data generated by its own business. It should be uncontroversial for the regulator to have unrestricted access to the entire database and individual lenders to have unrestricted access to their own data. All other access, direct or indirect, should be to anonymised data subject to minimum aggregation rules to prevent the identification of individual assets, loans, borrowers or lenders. Reports could also be produced to order by the database provider using the database, providing more insight to third parties or the market without divulging confidential information. It should be possible to find an acceptable compromise balancing the protection of confidentiality against the benefits of public access to granular information.

Commercial aspects and governance: In addition to promoting financial stability and better risk management, the database would have commercial value. Given the significant technical expertise and costs required to create and manage the database, the involvement of a specialist commercial database or index provider may be desirable, or inevitable. Governance would have to be in place not only to protect the confidentiality of data, but also to regulate the database provider's own rights to exploit the contents of the database, and the extent and terms of access to the contents applicable to third parties.

Similar or overlapping initiatives: A number of other initiatives similar to the database proposed by this Recommendation have been conducted, or are in place or under development.²⁶ Some of these focus on, or include, CRE finance.

- There may be things that can be learned or borrowed from such initiatives. Equally, good ideas or practice emerging from implementation of this Recommendation might usefully inform current and future work elsewhere.
- The development of consistent rules internationally, as well as between overlapping existing regimes nationally, would be valuable, in this as in many other areas.²⁷

²⁵ The practice in the CMBS context, for example, where regular reporting of bond, loan and property information to investors is well established, is for reporting on quarterly interest payment dates. Unsecuritised CRE loans generally provide for information reporting on a less frequent basis. Reporting may become more frequent when loans are stressed and covenants are breached.

²⁶ Examples of relevant initiatives with official participation are the European Central Bank's collection of information relating to CMBS bonds with templates for loan and property information as well as bond information; the UK PRA's recent 'property thematic' information gathering exercise with UK regulated CRE lenders; and the new EMIR, which introduces requirements for certain information relating to derivatives to be provided to trade repositories. One relevant industry initiative is the European investor reporting package (E-IRP) developed by the Commercial Real Estate Finance Council (CREFC) Europe, and derived from the more established US equivalent, to promote consistent data reporting to investors for CMBS and the loans and CRE assets that underpin them.

²⁷ It is hoped that this Recommendation would support compliance with other regulatory obligations to which particular lenders are subject (such as the European Banking Authority's new financial reporting (FINREP) and common reporting (COREP) obligations for credit institutions).

Recommendation 2 (Expertise and insight for the regulator)

The regulator should have access to expert interpretation and analysis of market information, particularly to give it insight into where in the cycle the overall market and individual market segments are likely to be at any particular moment. Expertise and insight from market participants and external experts should supplement and complement a well-resourced pool of CRE finance expertise within the regulator.

AIMS

To ensure that the regulator has adequate access to the internal and external expertise and insight required to interpret and analyse market information, allowing it to respond appropriately.

DISCUSSION

Expertise within the regulator: It is vital for the regulator to maintain an adequate level of specialist internal expertise in CRE finance, because it is a specialised area with a well-documented capacity to impact financial stability. Generalists are unlikely to be effective supervisors of CRE finance risk, particularly if different teams have responsibility for different participants in the sector (banks, insurers, investment funds, etc.) with no-one having explicit responsibility for the sector as a whole. The presence of CRE finance specialists at the regulator should also enhance trust and effective communication with regulated institutions engaged in CRE lending. The Government should ensure that adequate resources are available to the regulator to maintain CRE finance expertise, and the regulator must prioritise maintaining that expertise across the cycle. Above all, the regulation of CRE finance should not be light touch and low priority in the boom (when risk is building up) and heavy-handed after a crash (when risk is lower and the economy needs credit).

Experience within the regulator: One of the most effective guards against market and regulatory complacency is experience – specifically, in this context, experience of the last major crash.²⁸ The regulator should seek to ensure that within its CRE oversight function it retains individuals with such experience.²⁹

External expertise – an advisory committee of experts: In addition to sufficient internal CRE finance resources, the regulator should also have formal and reliable access to the best available analysis and objective interpretation of quantitative data. It should have similar access to qualitative expert opinion about aspects of the market that are not easily measured. An advisory committee of experts (including some with experience of prior market cycles) could provide analysis and insight to support the regulator's work, particularly if it had an explicit mandate to provide regular comment on key, objective market metrics. The committee should be designed in such a way as to counter any natural reluctance of industry participants to counsel caution in exuberant times.

- **Aims:** The expert committee would provide a qualitative expert view for the regulator (and potentially others interested in the CRE finance market), based on objective data and metrics, of approximately where the CRE market lies in the cycle.³⁰ It would also contribute to periodic reviews of the metrics and data used to monitor the CRE market to ensure they remain fit for regulatory purposes. Finally, the committee could comment on whether regulatory governors should be left 'on automatic' or whether regulatory intervention might be more appropriate.

²⁸ The CRE market cycle often suffers a relatively modest correction roughly half way between major crashes roughly ten years apart. Many influential market participants and regulators may be more relaxed than they should be as the next major crash approaches because their only experience of a crash is of the more modest variety.

²⁹ The same point applies to CRE lenders, as noted in the discussion of Recommendation 3.

³⁰ This would support the appropriate operation of regulatory governors, as proposed in Recommendation 7.

- **Terms of reference and approach:** The expert committee's terms of reference should be narrowly defined, focusing on its primary role of advising the regulator which quadrant of the cycle it believes the market is in.³¹ It should be recognised that the committee's advice may be granular and complex if different geographical or functional CRE sectors are behaving in different ways. The expert committee would specifically not be expected to predict the duration of CRE cycles or to forecast when market crashes will happen.³²
- **Metrics and data:** The committee would have regard to information emerging from and analysis based on the loan database, which will enable both lending behaviours and underlying property data to be monitored.³³ In addition, it would review macroeconomic lending data, credit conditions for property and for debt, and various CRE industry data sets.³⁴ Examples of key metrics likely to be relevant are given in Appendix 2 (Metrics for governors).
- **Composition of committee:** The committee should include experts from the CRE and CRE finance industries, but also individuals from beyond the CRE world bringing different expertise and who could help to contextualise CRE market signals and metrics against a broader, macro-economic backdrop. The involvement of industry outsiders is important partly to avoid an excessively narrow perspective and partly because CRE markets are in many respects responsive to external factors such as monetary policy, GDP, employment and consumer confidence.
- **Accountability for decision-making:** The Overview highlights the important role played by the regulatory cycle in allowing boom and bust to happen: historically, regulators have preferred light touch regulation that feeds the boom, then over-compensated after the crash in a way that worsens the ensuing bust. An expert committee might itself be susceptible to the mood of the market, reinforcing market and regulatory cycles rather than countering them; and industry participants on the committee may well be conflicted. That might lead the expert committee to promote pro-cyclical regulatory action, undermining a substantially automated, governor-based regulatory regime. Giving the committee statutory accountability might help counter that risk, by focusing committee members' minds on their responsibilities. Ultimately, however, the integrity of a through-the-cycle regulatory regime will be best protected by effective governors and a strictly advisory role for the expert committee. The regulator should not be able to share responsibility for its decisions with the expert committee.
- **Practical considerations:** The committee of experts should have regular engagement with and support from the regulator's own CRE finance experts. Its advice should be provided directly to senior individuals at the regulator. The degree of public transparency applicable to the expert committee's membership and its proceedings should balance the desire for public accountability with the need to encourage open discussion within, and with, the committee.
- **Relationship with other regulator/industry contacts:** The Group sees the expert committee as having a very precise and limited function that does not naturally fit with any other existing forum or group. Equally, however, the creation of an expert committee as proposed would in no way reduce the need for, or value provided by, other existing collective or bilateral contacts the regulator has with the industry.

A CRE crash plan: The regulator should consider using internal and external expertise while memories of a major crash are fresh to draw up a CRE crash plan.³⁵ Such a plan, which should be subject to regular review and updating as required, would provide at least a starting point for the regulator to implement an effective response confidently and swiftly in response to the next crash.

³¹ The four quadrants are expansion, slowdown, recession and recovery based on the OECD's business cycle clock, although alternative terms may be used. No more precise assessment than this is required or useful.

³² The use of regulatory governors rather than switches (see Recommendation 7) would require no more than a reasonable assessment of the current cycle quadrant so appropriate regulatory governors can be applied.

³³ See Recommendation 1.

³⁴ IPD and other data specialists already track most relevant industry data sets.

³⁵ This suggestion reflects the recognition, seen in the requirement for banks to have a living will, that it is better to produce analysis and consider all options in advance of a crisis, as there is unlikely to be the time to do so effectively after the onset of the crisis.

Recommendation 3 (CRE finance qualifications)

Key members of CRE lending teams and credit functions with responsibility for UK CRE lending, regardless of type of institution, should have an appropriately accredited CRE lender qualification, maintained through continuing professional education.

AIMS

To help ensure that lending initiators, decision makers and macro risk managers demonstrably possess the skills and expertise (as well as the experience) to understand the risks arising from individual property loans, the portfolio and the impact of the property cycle. That will give them the capability to evaluate the risk (and pricing) of loans appropriately, and to ensure property risks do not threaten their organisation.

To send a clear message to the market that CRE lending is a systemically important and complex specialist business justifying a gateway qualification for participants.

DISCUSSION

The importance of CRE knowledge: We saw in the last cycle that, despite the systemic significance of CRE lending, many loans were advanced – including by UK regulated SIFIs – on terms that would have been hard for an expert CRE lender to justify even at the time. While institutional and individual incentives³⁶ and other structural features of the market were partly to blame, it seems clear that many individuals involved in CRE lending simply lacked the expertise required to conduct that activity safely in a boom. Not only is CRE a highly cyclical sector; buildings themselves have a lifecycle, requiring periodic capital expenditure to retain their rental and investment value.³⁷ Lenders should not be beguiled by the deceptive simplicity of CRE finance into adopting a narrowly financial approach to risk and forgetting the physical nature of the asset for which occupiers are prepared to pay rent.

Educating lenders about property: While qualifications alone cannot guarantee wise lending decisions, the CRE finance industry, and financial stability more generally, would benefit from a more structured and consistent approach to training. CRE finance training provision is historically relatively modest:

- While there are numerous courses for students wishing to enter the UK property industry, very few specialise in real estate investment and finance, especially at undergraduate level.³⁸
- There are a number of good (if demanding) training options for CRE professionals seeking to improve their understanding of finance. Organisations like the College of Estate Management and the Investment Property Forum (IPF) Investment Education Programme and the Royal Institution of Chartered Surveyors (RICS) provide such courses.
- When it comes to educating financiers about property, however, there is little to choose from, and no market standard. Banks tend to hire generalist lenders rather than specialists, taking the view that it is easier for a generalist to be trained to apply his or her skills within a particular industry than for industry specialists to be taught banking. That judgment may be correct; but those involved in CRE lending would benefit from good quality CRE training in addition to ‘on the job’ training, and so would their institutions. Skills deficits can become particularly problematic late in the CRE cycle, when lending

³⁶ See section 2.2 Incentives, Recommendations 4 and 5.

³⁷ As noted in Appendix 1 (CRE and CRE finance in the UK), CRE is a depreciating asset class. Ignoring the market cycle, the rental value of a building will typically be lower at the end of a lease than it was at the beginning, in the absence of capital expenditure to enhance the building. That obviously affects the ease with which a loan can continue to be serviced after a lease event, as well as the refinancing risk and the enforcement value of the security. These are considerations that lenders should take into account in their exit valuations, risk assessment and pricing.

³⁸ As of mid 2013, there were more than 350 courses offered by more than 60 universities in the UK for students wishing to enter the real estate industry – but only nine of those courses specialised in real estate investment and finance, and seven of those nine were at post-graduate level.

volumes are likely to grow faster than the supply of experienced and appropriately skilled lenders. At present, it is up to individual institutions to commission or design their own training if they wish to, and practice varies.³⁹

Industry standards: Market participants, industry and professional bodies should work with educational establishments to develop foundation qualifications with appropriate accreditation for different levels of CRE finance professionals. Major lending institutions, in particular, should ensure that professionals with a meaningful CRE finance function should have a qualification appropriate to their role, representing the accepted industry standard.

- Different kinds of training would be appropriate for different functions within a lending institution. The primary focus for lending teams should be on understanding the features of, and risks associated with, the individual property or properties forming the collateral for a loan. For those making credit decisions or working in the central risk function of a bank, the emphasis should be on understanding portfolio and market level characteristics and risks.
- Continuing professional development (CPD) should be used to maintain expertise and complement growing experience.
- Institutions' training and development budgets could go further and there would be greater confidence in the knowledge level of lateral hires.

Scope: Ideally all CRE lenders, and not only the banking and wider regulated sector, should promote the acquisition and maintenance of appropriate qualifications by CRE finance professionals.⁴⁰

Mandatory or voluntary: The Group believes that the regulator's role should be to encourage the development of standard industry qualifications, rather than to mandate it. In the regulated sector, the regulator would take an institution's adoption and promotion of appropriate training into account as part of its overall assessment of the quality of that institution's risk management.

The importance of experience: While training has an important role to play, it is of course no substitute for experience – particularly experience of a major crash. Retaining individuals with such experience in appropriate roles within a lending institution is an effective way of guarding against complacency and over-exuberance.⁴¹

Real estate expertise: As a separate and additional matter, lenders can benefit from having in house real estate expertise to complement the more financial approach of finance professionals.

Balance between experts and non-experts: It is not suggested that all market participants and regulators who have contact with CRE finance should be CRE finance experts. Non-experts will always be able to add value, whether by countering the risk of regulatory capture or by bringing a broader perspective than specialists will generally have. The key point is that there must be CRE finance expertise within key CRE loan approval and portfolio/macro risk oversight functions.

Standards of competence in banking more generally: The Banking Standards Review undertaken by Sir Richard Lambert⁴² has identified the importance of well-defined professional standards for the banking industry. In particular, it recommends supporting the work of existing professional bodies to develop consistent baseline levels of competence for banking professionals, not least to recognise the wider social context in which they conduct their activities. There are important differences between Sir Richard Lambert's work and that of this Group. His focus is on the banking sector as a whole, and on promoting a

³⁹ The need to provide some sort of validation of the standard of internal training more generally is noted by Sir Richard Lambert's Banking Standards Review (see <http://www.bankingstandardsreview.org.uk/>). Inevitably, the importance attached to training also varies depending on how fresh memories are of mistakes made in the lead up to the last crash. A firm market recognition that specified standard qualifications are expected of CRE finance professionals could help counter this particular aspect of the cycle too.

⁴⁰ For bankers, this could form part of the approach proposed by the Banking Standards Review for promoting high standards of competence, assuming those proposals are taken forward.

⁴¹ The same point applies in relation to the regulator, as noted in the discussion of Recommendation 2.

⁴² See <http://www.bankingstandardsreview.org.uk/consultation-paper/>.

more socially responsible, customer focused ethos. Ours is on improving the relationship between the broader CRE lending industry and financial stability. However there is good alignment between the two initiatives and there is a particularly obvious overlap in the area of professional standards of competence. This Recommendation can contribute to the success of the Banking Standards Review and deserves its support. Most importantly, we hope that the Banking Standards Review will recognise the contribution that CRE sector specialist organisations (as distinct from professional banking bodies) can make to the promotion of better educational and professional standards.

2.2 Incentives

As well as having appropriate information and expertise, it is essential that those involved in CRE lending are incentivised in a manner that promotes a more stable and resilient CRE lending market with the features outlined in the Overview section on The envisioned market and its features. With the wrong incentive structures, the effectiveness of other regulatory or industry initiatives (including the Recommendations in this Report) will be limited. That is true both at the individual level and at the institutional level. This section introduces two recommendations,⁴³ concentrating primarily on banks and other institutions that are subject to regulatory capital requirements, for reasons explained below.

INDIVIDUAL INCENTIVES

Since the GFC, there has been extensive public discussion and regulatory action on incentive structures for individuals working in banks and other financial services businesses. The Group agrees that individual incentives are critically important, but in the absence of any specifically CRE lending angle the Group did not feel it could add to the work already being undertaken. The Group supports the trend towards greater deferral of remuneration and the possibility of claw backs in the interests of better alignment of individual incentives with actual economic outcomes, which in financial services typically only become known much later than the period in which a product is sold. Individuals should not be able to 'bank' outsized financial rewards for sales that might end up giving rise to large losses for their organisations or their investors.⁴⁴

INCENTIVES FOR BORROWERS

It takes both a lender and a borrower to make a bad loan. That is not to say that borrowers should be held responsible for the excessive lending that led to the under- and non-performing CRE loans that clogged up banks' books during the GFC. A lender's bad deal (too much lent at too low a margin) is typically a borrower's good deal (plentiful cheap capital). It would be difficult to justify penalising borrowers for achieving a successful commercial outcome. However, borrower appetite for imprudent loans is undoubtedly a contributory factor to bad lending decisions. For that reason, it is worth considering whether and how the incentives for borrowers might be altered to promote more responsible and sustainable lending, and better outcomes for the broader financial system.

- Enhancing directors' duties and imposing punishments for reckless borrowing are unlikely to be effective (even leaving to one side the fact that it is the lending, not the borrowing, that is reckless). It would be difficult to convict directors of crossing an unclear line that will inevitably feel somewhat arbitrary, particularly when a large part of the market may have been acting in a similar way.⁴⁵
- The main disincentive against over-gearing by borrowers is the risk of losing equity, but in practice that disincentive may not be very effective. The use of limited liability vehicles and structures limits the lender's recourse to the investor, whose downside risk is capped at the equity in the vehicle itself. For

⁴³ Recommendations 4 and 5.

⁴⁴ Ultimately, better rules for determining appropriate capital charges at the institutional level (discussed below) could also provide valuable information for assessing the true financial value generated by individuals' lending activities. That in turn, could facilitate a move away from simplistic, volume-based reward structures for CRE lending, and towards appropriately risk-adjusted measures. Such a move would create better alignment of interests between CRE lending professionals and the institutions they serve.

⁴⁵ The possibility of loan to value caps is considered in the discussion of Recommendation 4 below.

the investor, borrowing as much as possible can become attractive, because extra debt increases the potential return on equity and reduces the equity at risk. This incentive is magnified if the pricing of debt fails to reflect the risks of lending into the CRE market as the cycle moves towards its peak. However, as a practical and legal matter, restricting the use of limited liability vehicles and structures – which are often commercially necessary for pooled investment structures – does not seem a proportionate or realistic way forward.

- Canny investors may be able to persuade a lender to re-gear an existing loan by reference to a new, higher market valuation. The proceeds of the new loan may be sufficient to return all the originally invested equity to the investor, and even a profit on top. The result is that the investor retains the equity upside, but only the lender has funds at risk. However, the superficial attraction of restricting revaluation-based regearing by borrowers should be resisted. It would be distortive, creating an artificial incentive for asset disposals through which revaluation benefits might be captured. It would also be unfair and economically damaging, because it would make it relatively more expensive for the long-term owner of depreciating CRE assets to fund improvements.
- One of the benefits of high leverage for many investors is the tax deductibility of financing costs (subject, admittedly, to various complex rules). One way of dampening the demand for CRE debt at levels that pose risks to financial stability might therefore be to remove the subsidy the tax system provides for them, by restricting the tax deductibility of financing costs above specified original LTV levels.⁴⁶ Such an approach would not be uncontroversial or straightforward, and would present implementation and transition challenges. However, unlike the approaches mentioned above, it is not obviously problematic in any fundamental way. There is therefore a policy case for restricting a tax incentive that can undermine financial stability.
- At a more basic level, however, higher capital costs in the regulated sector for riskier CRE loans should translate⁴⁷ into higher financing costs on higher risk loans. That should serve to reduce borrowers' appetite for loans that effectively transfer equity-like risk to regulated lenders.

INSTITUTIONAL INCENTIVES

Regulatory capital and economic risk: For banks and other regulated lenders, capital requirements are probably the most important tool available to the regulator for creating an incentive framework within which the market can self-manage. Regulatory capital requirements are most effective when they are well aligned with economic risk. However, economic risk can be difficult to assess accurately, especially in a heterogeneous, long-term and cyclical market environment. An added complication is that economic risk may look different from the point of view of a lending institution compared to the point of view of the financial system as a whole. Capital requirements offer a way of internalising systemic risks for lending institutions that might otherwise be quite rationally inclined to ignore them.

Scope of regulatory capital regimes: Regulatory capital requirements do not apply to, and are not appropriate for, all financial institutions or, indeed, all CRE lenders. For the purposes of this Recommendation, they should only apply to types of lender that are (as a category) systemically significant. That most obviously encompasses banks, may apply to certain other financial institutions such as insurance firms, and could conceivably be extended to investment management firms. At this stage, at least, the regulatory capital element of this Recommendation should not generally apply to private funds.⁴⁸ The overall scope of capital requirements, as well as their structure, must be kept under review and regulators must look out for new types of entities becoming systemically important, either individually

⁴⁶ For these purposes, it would make most sense to determine LTV using long-term value (as proposed in Recommendation 4).

⁴⁷ Through appropriate loan pricing and terms, and supported by the adoption of internal reward systems for CRE lending that better reflect the true risks and capital costs of such lending.

⁴⁸ Private debt funds may be subject to capital requirements, for example under the Alternative Investment Fund Managers Directive, but those are not investment-by-investment, risk-weighted capital requirements, and are intended to provide a degree of protection for investors rather than for financial stability.

SECTION 2: RECOMMENDATIONS

or as a category.⁴⁹ In appropriate cases, the imposition of regulatory capital requirements on newly systemically important lenders may be required to protect financial stability.

Consistency between regulatory capital regimes: Regulators need to consider the diverse ways in which regulatory capital regimes can affect markets and the behaviour of market participants. Existing rules already contemplate differentiated capital requirements having regard to the extent to which a particular institution is systemically significant, even within a single type of regulated entity.⁵⁰ Different types of differently regulated financial institutions operate in the CRE lending space as well as carrying on other activities. Regulators need to be mindful of the overall picture, recognising that a regulatory treatment that makes sense in one context may create regulatory inconsistencies in another. Regulation can distort an organisation's allocation of capital (towards or against CRE lending), or it can privilege one type of market participant over another, or one form of exposure over another. Whether regulation is deliberately seeking to influence behaviours or not, the consequences may not always be intended or desirable. Faced with regulatory arbitrage opportunities, capital providers and banks and other intermediaries will often prefer the cheapest, least regulated route, such that systemic risk builds up outside the regulator's field of vision. There is no simple solution to this problem. What matters is that regulators are aware of it, and that they periodically look up from the particular types of institutions they regulate to see the bigger picture.⁵¹

- **Non-bank regulated lenders:** While banks (and especially UK banks) have already absorbed a lot of regulatory change in recent years, there is more in the pipeline, particularly for other kinds of lenders. To the extent that risk based capital requirements are imposed on insurers,⁵² pension funds or shadow banking organisations, the UK should seek to ensure that the relevant regimes apply the same principles as are recommended in this Report, albeit the regimes may legitimately be different.⁵³
- **International consistency:** More generally, just as regulatory consistency across the cycle would be valuable, so would consistency across borders. Better cross-border alignment of rules could limit the extent to which sensible regulatory reform in the UK might put UK banks and other regulated lenders at a competitive disadvantage. It could also reduce the vulnerability of the UK market to distortive inbound capital flows because other jurisdictions are regulating less effectively. International consistency should also limit the room for other forms of regulatory arbitrage, such as loans being booked in a jurisdiction different from the location of the collateral.
- **Regulatory differentiation and competitiveness:** A balance needs to be struck between entity-appropriate regulation and the effect of differentiated regulation on competition. The competitiveness of highly regulated lenders should be compromised only so far as necessary to protect financial stability, having regard to their role in the wider economy. By aligning regulatory capital requirements with true economic risk, the Recommendations in this section seek to minimise distortion of competition.

Importance of effective regulatory capital rules for CRE lending: The way in which regulatory capital requirements deal specifically with CRE lending risk is very important, for at least three reasons.

- Responsible CRE lending by banks is essential for the health of the economy. UK banks continue to be the dominant providers of debt funding to the UK CRE sector, as can be seen from Figure 4. Historically, UK banks and building societies have also been the only reliable source of CRE finance for smaller assets and borrowers, particularly in the regions.

⁴⁹ This requires the regulator to have accurate and reliable data about the CRE activities of lenders who fall outside the regulatory perimeter. Recommendation 1 should provide that, by capturing data from all UK CRE lenders.

⁵⁰ For example, banks that are identified as locally or globally systemically important face additional loss absorbency requirements in the form of capital surcharges above the minimum requirements more generally applicable under Basel III.

⁵¹ This is, in fact, one of the reasons why the Group believes a vision is necessary. Recommendations 1-3 should all help in this regard.

⁵² Aspects of the capital charges proposed under the incoming Solvency II regime for insurers seem likely to distort behaviour because of their poor alignment with economic risk. For example, it is understood that capital charges for direct lending do not generally take account of the existence of collateral. Another example is that equivalent CRE lending risk carries very different capital charges depending on whether it takes the form of a direct loan, a holding of covered bonds or a holding of CMBS. It is hard to predict how these features of a new regulatory environment will affect the behaviour of insurers, who are a natural and appropriate investor base for CRE debt, but the lack of consistent economic logic is concerning.

⁵³ Recommendations 4 and 5 in particular should inform the design of any risk based capital requirements for non-bank CRE lenders.

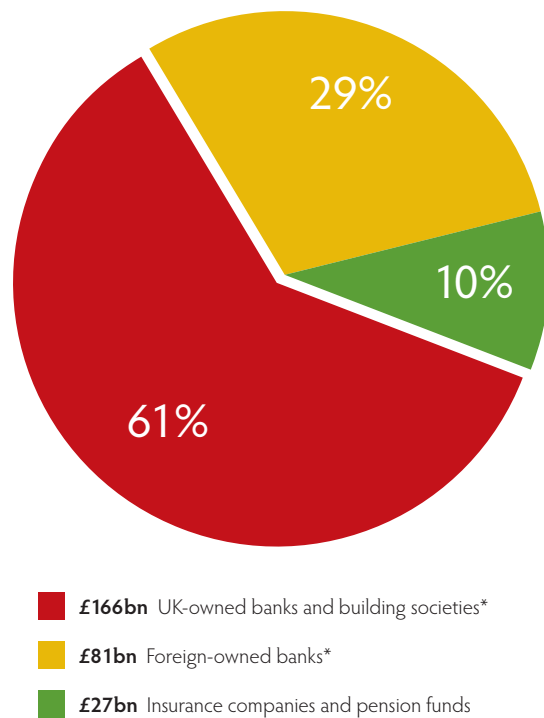
- CRE lending can adversely impact financial stability. Near the peak of the cycle, CRE lending can exceed 10% of total bank lending, as Figure 5 shows. As the peak is followed by a fall, CRE exposure has a history of causing serious problems for over-extended financial institutions and helping trigger financial downturns.⁵⁴
- The relative treatment of CRE lending and other forms of lending can cause capital to be diverted either into, or away from, real estate, to the detriment of the economy as a whole.⁵⁵

Past and present capital regimes for CRE

lending: Regulators have not yet found an effective way to set capital requirements for CRE debt. None of the standardised approach,⁵⁶ the internal ratings-based (IRB) models,⁵⁷ and the alternative solution of supervisory slotting⁵⁸ appear capable of encouraging the right outcomes. To some extent, these problems are the result of the regulatory cycle (i.e. insufficient rigour in implementation during booms), but inherent weaknesses in the regimes are also responsible.

- The standardised approach is not risk-sensitive in the context of the overwhelmingly private and unrated CRE lending market. As a result, it creates a perverse incentive (particularly dangerous in the competitive environment of an overheating market) for lenders to move up the risk curve in pursuit of better returns, without the discipline of capital rules to encourage appropriate pricing.
- IRB models present challenges (particularly, but not solely, for non-specialist regulators) because of their complexity and the lack of adequate historical data to demonstrate that they appropriately assess CRE lending risk.⁵⁹

Figure 4: **Lenders to CRE companies**

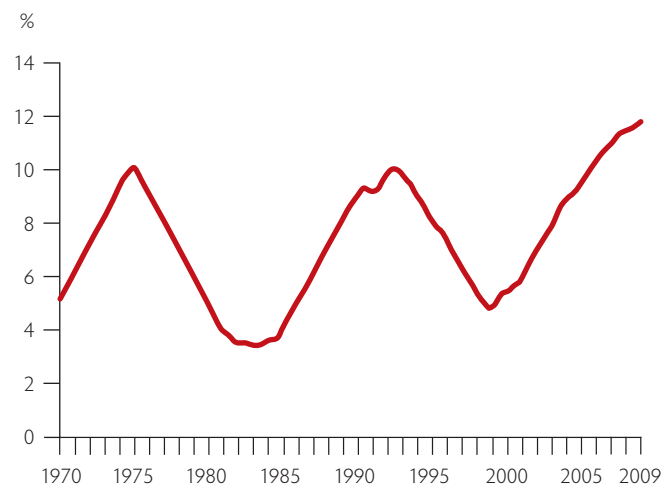


* Includes CMBS

Source: Bank of England

Note: All figures are indicative, based on various available data sources. Figures refer to end-2010 data where possible.

Figure 5: **Property debt as a proportion of banks' total lending**



Source: Bank of England

⁵⁴ This can be seen in Figure 3 in Section 1 (Overview).

⁵⁵ This is a separate and additional point to that made above in relation to arbitrage risk as regards the relative cost of different routes to CRE debt risk and returns for investment capital.

⁵⁶ Under Basel I (and rolled forward under Basel III/III).

⁵⁷ Permitted under Basel III/III.

⁵⁸ Contemplated by Basel II and III in relation to specialised lending exposures such as IPRE, where an institution using an IRB approach does not have an approved model for dealing with such exposures.

⁵⁹ As mentioned in the discussion of Recommendation 5, better data (Recommendation 1) and better levels of expertise (Recommendation 3) could make the safe development, approval and use of IRB models a more realistic prospect.

SECTION 2: RECOMMENDATIONS

- Slotting is crude and simplistic; it imposes unreasonably high capital charges on the safest loans and capital charges that are too low for the riskiest loans (in both absolute and relative terms). It creates adverse selection risks for UK banks that are subjected to it, inappropriately distorting competition to their detriment as against other lenders, who are not.⁶⁰
- More generally, subjective approaches to risk assessment (including slotting) are inherently vulnerable to cyclical variations in the perception of risk. Risk is always under-estimated during a boom, so such capital rules cannot operate either to deter excessively risky loans or to mandate the right level of capital in respect of them. The shortfall in capital becomes apparent after a crash, when everyone realises how risky some of those boom loans really were. Judgment-based capital rules thus fail to discourage excess liquidity and risk-taking in the boom, and aggravate the credit drought after a crash.

Regulatory capital requirements must be used more effectively to balance institutions' incentives in CRE lending in a more appropriate way in time for the next cycle.⁶¹

Accounting rules: Changes are proposed to the international financial reporting standard for financial instruments (IFRS 9) that are expected to require future expected losses to be taken into account in the calculation of provisions. That seems to be a sensible development in broad terms in the context of CRE debt, and one which aspects of this Report should support.⁶² However, accounting rules are not primarily directed at protecting financial stability, and while these changes may help resolution after a crash by promoting timely recognition of losses, they are unlikely to affect lending decisions in a boom. For that, we need a more intelligent regulatory capital framework, which anticipates during the boom the capital that regulated lenders are likely to need after the crash.

Regulatory support for the chief risk officer (CRO): In the build-up to a boom, as market risk and competitive pressures increase, the role of a SIFI's CRO is increasingly important. CRE booms can last for many years, and with each passing year in which the market remains strong the cautionary voice of the CRO finds it harder to be heard in the face of the business drive to benefit from the boom and increase sales and short-term returns.⁶³ When it comes to protecting the balance sheet solvency of a regulated lender through the appropriate assessment of CRE lending risk, the backstop for the CRO is the requirements of the regulatory regime. Absent appropriate regulatory support, the CRO's influence risks being ineffective just when it is most valuable. Structures should be in place to ensure CROs remain influential, and the incentives for the CRO should be linked to, and support, sound risk assessment and management and relevant regulatory compliance by the organisation. Regulated entities should be incentivised and encouraged to recruit and retain high quality CROs and ensure their independence, objectivity and influence within their organisations.

⁶⁰ This is most apparent at the safest end of the CRE lending spectrum, where the risk weights imposed under slotting threaten to price UK regulated banks out of the market – even though it would be good for their safety and stability if they held such loans.

⁶¹ We believe that Recommendations 4 and 5 can achieve that, by introducing a counter-cyclical valuation measure into the capital regime and aligning capital requirements more closely to economic risk.

⁶² In particular, the creation of a comprehensive CRE loan database (Recommendation 1) and the availability of consistently appraised long-term valuations alongside current market valuations of collateral (Recommendation 4).

⁶³ At the same time, lower funding costs for banks as the cycle progresses combine with competitive pressures to push margins for loans down, even as the risk of those loans increases.

Recommendation 4 (Use of long-term value⁶⁴ measures for risk management)

For CRE lenders subject to regulatory capital rules, loan-to-value (LTV) based capital requirements should be linked to a long-term measure of collateral value that is insensitive to the investment cycle.

AIMS

To protect the balance sheet solvency⁶⁵ of regulated UK CRE lenders by placing a fundamentally counter-cyclical and automated mechanism at the heart of the regulatory capital rules for CRE lending which:

- ensures the build-up of adequate regulatory capital as the market rises, providing regulated lenders with the desired level of regulatory capital after a CRE market correction;
- dampens credit growth during a boom, reducing the potential for regulated lending to feed a CRE bubble by breaking feedback loops between valuations and lending; and
- does not discourage relatively low-risk CRE lending after a crash, when investment in the sector is most needed.

In the process, to establish a through-the-cycle measure against which point-in-time collateral values can be compared on a loan-by-loan, loan-book, sub-market and market basis, to facilitate understanding of where in the cycle the market sits at any particular moment.

This Recommendation does not seek to change or replace the way in which market values are determined and used in the market. It seeks solely to supplement the information available to regulated lenders and the regulator with a metric specifically intended to inform risk management and regulatory capital requirements.

DISCUSSION

This discussion is structured in three parts. First, we discuss the role that a cycle insensitive, long-term value concept could play in supporting risk management (by both lenders and regulators). We then explore the long-term value concept in a little more detail (boxed section). Finally, we discuss incorporating the concept into regulatory capital rules.

Risk management in CRE finance

Assessing CRE lending risk: Perhaps one of the hardest – as well as the most important – judgments faced by CRE lenders and regulators alike is assessing the level of risk arising from CRE loans. If lenders and regulators are to understand the risks in CRE lending, at the point a loan is made and at the portfolio and market levels, a reliable means of assessing CRE lending risk is required.

Use of loan to market value to assess CRE lending risk: Traditionally, much weight is placed on the proportion that the amount loaned represents against the market value of the collateral (referred to as loan-to-value ratio or LTV). It is understandable why this approach is popular, but it has both advantages and disadvantages.

- In broad terms, high LTV lending is riskier, because relatively small falls in property values can reduce or eliminate the equity cushion protecting the lender. Low LTV lending is generally safer because, even in

⁶⁴ The Group believes that the term 'long-term value' adequately conveys the key feature of cycle-insensitivity, without implying (through a reference to 'sustainable' values) that underlying CRE values are fixed over time.

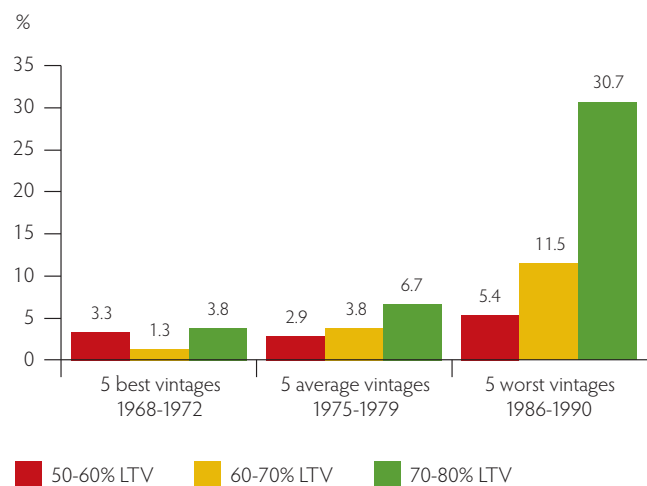
⁶⁵ The focus here is on value/economic balance sheet solvency (i.e. economic positive net equity). Cash flow or liquidity solvency can be managed separately through duration/maturity risk management and potentially liquidity support (see the paragraph on the use of very low risk CRE loan exposures as collateral with the Bank of England in the discussion of Recommendation 5).

SECTION 2: RECOMMENDATIONS

extreme stress scenarios, the value of the collateral is more likely to be sufficient to fully protect the lender's position. At any given point in the cycle, therefore, LTV is a good way of comparing the relative risk of otherwise similar CRE lending opportunities.

- However, risk also needs to be understood in absolute terms and against the backdrop of a cyclical and volatile CRE market.⁶⁶ A loan with a 75% LTV at origination can become a 100% LTV loan a year later if the value of the property falls by 25% during that period. Tracking movement in the LTV ratio (something that is often mandated by LTV covenants in the loan documentation) offers a way for the lender to monitor property specific issues that may affect the performance of the loan. If however the lender holds a portfolio of loans and the fall in values is cyclical, and therefore correlated across that portfolio, the signal of rising LTVs will almost certainly come too late. Indeed, it is at the point of origination that lenders most need to be aware of where in the cycle the market is: that is when they price risk and commit capital. Market value based (i.e. point-in-time) LTVs are not especially helpful in that context, as Figure 6 illustrates.
- Relying on market value based LTVs to assess risk is positively dangerous in a rising market, because it exaggerates the cyclical nature of lending.⁶⁷ As market values rise, LTVs on existing loans fall, creating an illusion of CRE borrowing capacity in the market and of low overall levels of risk. Lenders respond by increasing their targeted CRE lending volumes in pursuit of increased returns, and their maximum LTV lending limits due to the perception of lower risk in a strong market. At the same time, cash flow coverage and margins fall, as property yields fall and lenders compete for business. Competitive pressure is increased by new entrants, drawn to apparently easy profits driven by rising property values. At this point in the cycle, rising property values are more likely to be the result of markets placing higher values on cash flows, than of actual cash flow growth. The plentiful supply of cheap debt in turn increases the amount property investors can pay, pushing values even higher.⁶⁸

Figure 6: **US commercial loan default rates**



Source: Moody's Investors Service, Inc., 'Frequency of Credit Events by Initial LTV Group: Best, Average, and Worst Cohorts' Figure 4 from Moody's Special Report: U.S. CMBS: Case Study of Leverage and Default Risk over a Full Real Estate Cycle.

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Use of long-term value to assess CRE lending risk: Market value based LTV reflects the cycle, so lending decisions linked to such a measure will tend to feed the cycle and increase exposure to it. That is a fundamental flaw when it comes to assessing and managing cyclical risk and protecting financial stability. This problem could be substantially mitigated if LTV was calculated by reference to the long-term value of the property supporting each loan, rather than its point-in-time market value. That would break the link between LTV and the cycle, while preserving the link to the individual property that allows the risk of an individual loan to be assessed and monitored. Long-term value would act as a relatively fixed, cycle-

⁶⁶ As discussed in Section 1.1 (Setting the scene) in the Overview, the volatility and cyclical nature of CRE markets is partly an intrinsic feature resulting from the elasticity of demand (both from occupiers and from capital seeking CRE exposure) and the inelasticity of supply (developing or modifying buildings requires planning permission, finance, and construction work). However, market sentiment and the credit cycle exaggerate that volatility, because market values are partly a function of the multiple the market is willing to apply to a property's cash flows at any given point – and that varies across the cycle, and depending on the amount of liquidity in the system.

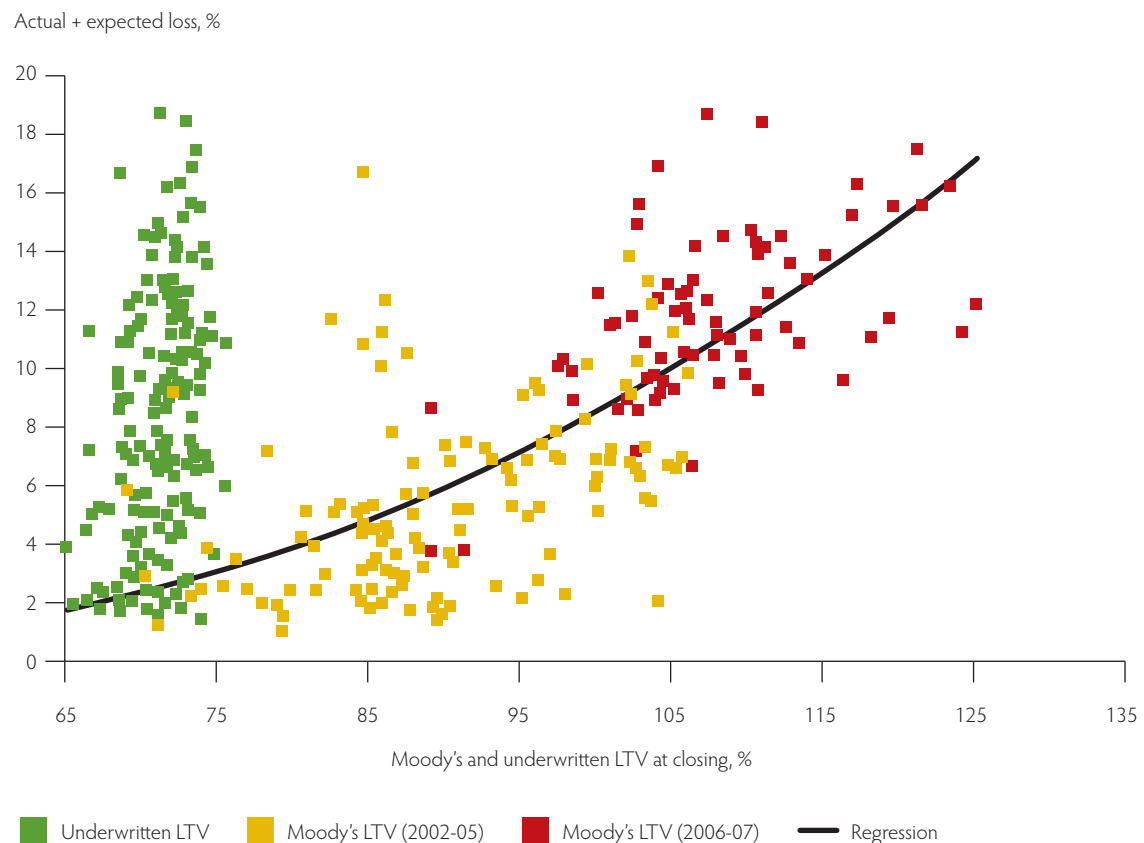
⁶⁷ As explained in Section 1.1 (Setting the scene).

⁶⁸ The effect is almost as invidious at the bottom of the market. Calculating LTV using market value adds to the cyclical distaste for risk and restricts the flow of credit when asset prices are already depressed below their long-term trend and the market needs credit to recover and to make it easier for existing loans to be refinanced. Without finance, transactions cannot take place and values cannot recover. The cyclical volatility of credit flows into CRE can be seen from Figure 1 in Section 1 (Overview).

insensitive reference point against which to judge point-in-time valuations. Its use would eliminate the pro-cyclical deception whereby rising market values flatter LTVs and encourage imprudent lending. As market values move past the cycle average and the gap between the two measures grows, the closer the market must be to the next turning point. Keeping track of both the current market value and the long-term value of the assets securing their CRE loans would provide lenders, and their regulator, with valuable information about the cycle and risk, and should have a positive impact on lending behaviours and, consequently, on financial stability.

Recent loan performance and LTV based on market values and long-term value: The vulnerability to cyclical volatility of LTV based on market value, and the contrasting cycle-insensitivity of long-term value based LTV, can be seen from Figure 7. It plots the performance of a group of CMBS loans benchmarked simultaneously by point-in-time LTV (as calculated by the CMBS originator), and by a measure of long-term value based LTV, as developed by Moody's, a credit rating agency. The data support the thesis that loans made at similar market value based LTVs (in this case, 75%) have wildly different risk profiles, and will exhibit commensurately different loss experiences. The principal explanatory variable is when in the cycle the loans were originated (and the point-in-time valuation was produced). Moody's LTV (based broadly on long-term value principles) proves itself a far better guide to performance than LTV based on market values.

Figure 7: **Performance of US CMBS loans measured by LTV**



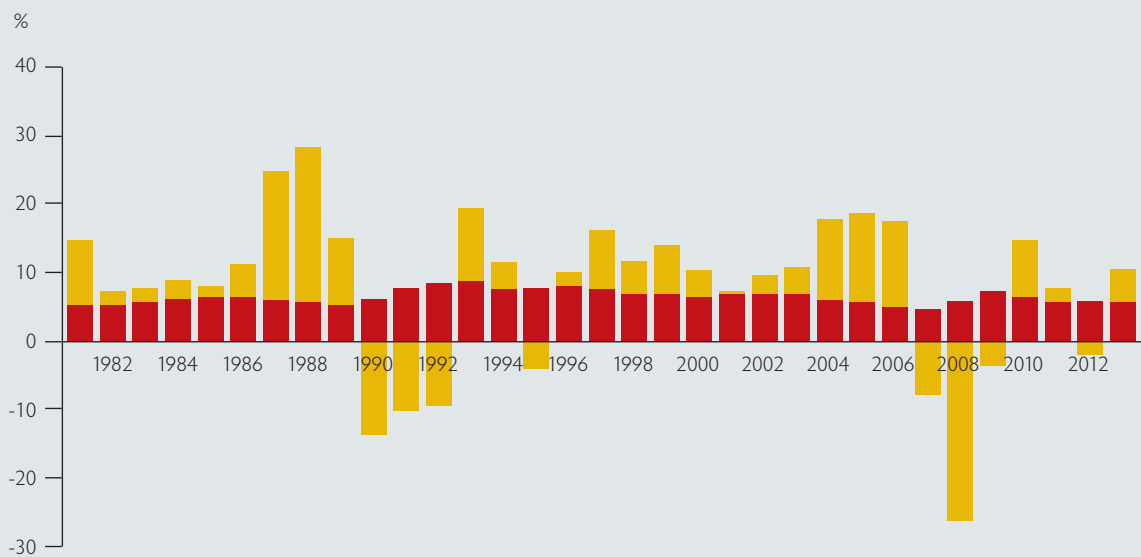
Source: Moody's Investors Service, Inc., 'MLTV Flagged Growing Risk in Peak Vintage Deals' Exhibit 1 from Moody's Special Comment: US CMBS: New Database shows that Moody's loan level credit metrics effectively differentiate default risk.

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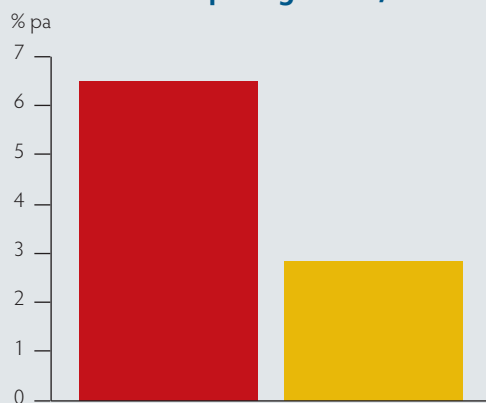
The long-term value concept

The importance of cash flow: The long-term, sustainable cash flow that a property is able to generate is only one element that determines market value – the other principal element is the capitalisation rate used by the market, and that varies greatly across the cycle. Long-term value strips out the volatility of overall market capitalisation rates, so it more closely reflects the anticipated cash flows (i.e. chiefly net rental income). Long-term value would change in response to changing expectations regarding a property’s sustainable income-generating potential, but would be unaffected by the volatility of market capitalisation rates. Data from the IPD UK Annual indices covering more than 30 years demonstrate how much more stable and consistent UK CRE income returns overall are than capital growth see Figure 8.⁶⁹

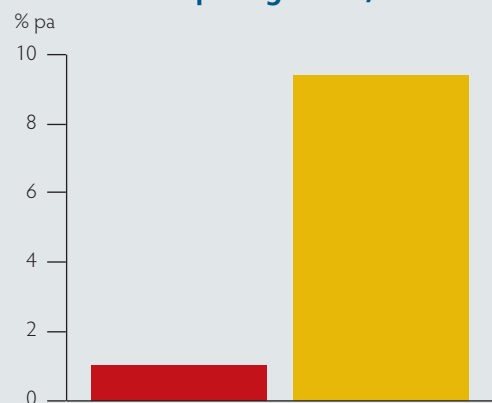
Figure 8: Long-term real estate returns – components of performance



Average annual income returns and capital growth, 1981-2013



Volatility of income returns and capital growth, 1981-2013



Income return Capital growth

Sources: Fidelity International; IPD UK Annual Digest December 2013

⁶⁹ Although movements in property yield account for a significant proportion of the cyclical swing in CRE values, CRE markets (particularly in certain sub-sectors, such as large offices) can exhibit very pronounced rental cycles that further exacerbate the property cycle. For example, IPD data show that over period 1983-2013 the volatility in rental growth in West End offices (the UK’s largest office market) has contributed slightly more to the volatility in annual capital growth than movements in commercial office yields.

Defining long-term value: The Group recognises that there may not be a single, simple way of formulating the long-term value concept. The UK has an exceptionally strong tradition in market value valuation, underpinning a very liquid and transparent CRE market, but no such tradition of measuring long-term value. Without a doubt, developing appropriate methodologies and standards for long-term value presents choices and challenges that will require the participation of professional valuation and surveying bodies as well as CRE finance specialists. Some examples of possible approaches to defining long-term value follow, but this Report does not seek to set out a prescriptive definition.

Precedents for long-term value: The fact that there are various examples of approaches using long-term value principles suggests that the challenge of developing a workable approach for the UK CRE market should not be insurmountable.

- One such example is the Beleihungswert ‘mortgage lending value’ that underpins Germany’s Pfandbriefe market.⁷⁰
- Another can be seen in the rating agencies’ CMBS rating methodologies, which apply long-term value principles (improved since the GFC) for assessing the quality and risk of CRE related securities without being distracted by the cycle.⁷¹

Considerations in developing the long-term value concept: While the UK could choose to adopt a model for long-term value already in use elsewhere, a new approach (albeit benefiting from the experience of others) may be better able to meet the specific objectives of the vision in the context of the UK CRE market. In exploring the options, the following considerations might usefully be taken into account:

- The long-term value approach does not have to be perfectly precise in relation to all CRE loans, provided it is reasonably accurate in relation to the overall CRE loan book. The principal objective is to ensure that regulated CRE lenders have sufficient regulatory capital in respect of their total CRE loan books to withstand a market crash without needing significant equity support from the state. An approach to long-term value would be acceptable if it delivers the right aggregate level of regulatory capital for a CRE lender, even if that approach is difficult to apply accurately in relation to a small proportion of a regulated lender’s CRE loan book.⁷²
- In order to ensure the sufficiency of regulatory capital, a reasonably accurate and reliable means of assessing the level of losses likely to result from a market crash is required. If the desired level of capital cannot be determined with reasonable accuracy, the result will be either (a) too little capital (and a need for the state to

⁷⁰ A German covered bond market dating from 1769, available only to licensed institutions and the criteria for which are prescribed by legislation. The mortgage lending value limits for Pfandbriefe eligible CRE lending use a valuation approach that looks beyond current market values, supporting sustainable high ratings for the bonds. One feature of Germany’s Beleihungswert valuation approach is that it focuses on a sustainable value that generally sits at or below the lowest prices in Germany’s rather less volatile CRE cycle. That feature effectively disables the potential counter-cyclical impact that our proposed long-term value concept could provide at the bottom of the cycle, while maximising the counter-cyclical protection offered at the top of the cycle.

It should be noted that mortgage lending value is entirely an internal matter for German mortgage banks: it is calculated by internal valuers and is not discussed with borrowers or used in financial covenants.

⁷¹ For example Moody’s approach (described in a December 2013 CMBS rating methodology paper available for subscribers at https://www.moody.com/research/Moodys-Publishes-EMEA-CMBS-Methodology-Update--PR_287890) includes a ‘minimum yield’ concept designed to smooth out market perception of the value of cash flows:

“Minimum yields allow for greater stability of Moody’s property values throughout market cycles to mitigate the market value volatility associated with commercial real estate (CRE) prices.”

“CRE loans, especially those subject to balloon risk as typically found in CMBS transactions, are invariably exposed to market cycles. The value of the underlying collateral property is a key factor in our credit assessment of CRE loans and impacts, amongst others, our refinancing risk and our loss severity simulation. Property values can vary over the cycle, most notably through fluctuations in property yields that at times can be more volatile than the property’s cash flows.”

“In the case of peak market conditions with low property yields, the minimum yields will effectively cap our value assessment for a given property cash flow. We typically derive our value assessment by applying Moody’s market yields to our property cash flow expectations. To avoid strong fluctuations of our property value assessment due to market yield volatility, we use minimum yields.”

⁷² For example, lending against construction/development projects and land banks poses particular challenges in this context for a metric fundamentally linked to cash flow. While development finance was not a significant factor in the UK’s experience of the GFC, it has been significant in other CRE crashes, so it should certainly not be ignored. Rather than complicate the development of the long-term value concept in relation to stabilised, income-producing assets, it may be better to consider alternative approaches for dealing with development finance – probably in a way that translates to a long-term investment value as the asset itself evolves into an income-producing asset.

provide undesirable levels of support after a crash), or (b) too much capital (reducing market efficiency and compromising the ability of regulated lenders and, through them, the CRE industry, to support economic growth). Both of those outcomes would distort market behaviour and neither is consistent with the objectives of this vision. Approaches to long-term value that are conducive to reasonably accurate and reliable assessment of capital requirements in the event of a CRE market crash are therefore strongly preferred.

- While any long-term value methodology need not produce accurate results for any particular property, it is very important that it should produce consistent results across different lenders and valuers. It may therefore be necessary to limit flexibility, for example by prescribing the discount rate (or yield or multiple) applied to cash flows to arrive at a long-term value.
- Having said that, the Group does not want to be prescriptive. Different approaches may be worth exploring, such as: discounted cash flow methodologies; approaches based on income capitalisation rates; cycle-average values or adjusted values derived from historic market valuations, such as a minimum value from a trailing multi-year window; or look-up tables.
- The long-term value concept need not be completely insensitive to the cycle from the outset. While that would be ideal, a model with some sensitivity to the cycle could be an acceptable starting point if more data and experience would allow that sensitivity to be reduced over time.

Determining long-term value: Valuation of underlying collateral on long-term value principles should be carried out independently of any other valuation, in accordance with principles and assumptions to be determined, when a loan is made. Long-term value should be monitored, and almost certainly periodically refreshed, during the life of the loan, alongside (and not in substitution of) other kinds of valuation that lenders and borrowers may desire. In particular, it is anticipated that the primacy of market value valuations would continue for other purposes.⁷³

Other complementary risk management metrics: While the Group believes that long-term value would be a powerful risk management tool, other factors and metrics remain important in the assessment and management of CRE lending risk.⁷⁴

Incorporating the long-term value concept into regulatory capital rules

Regulatory capital and LTV: While the mere use of long-term value should improve risk management and information for CRE lenders and the regulator, the greatest opportunity is in extending the concept and linking regulatory capital requirements to long-term value based LTVs. The purpose of regulatory capital requirements is to ensure that the economic risk to which lending institutions are exposed is reflected in adequate capital to protect financial stability.⁷⁵ Market value based LTVs are not a helpful input for that process, because of their sensitivity to the cycle.⁷⁶ Long-term value based LTVs, on the other hand, are specifically designed to capture cyclical risk in CRE lending, so would be an ideal tool in determining regulatory capital.⁷⁷ The effect would be to restrict exuberant lending by regulated lenders as market values accelerate above long-term values, while also ensuring that adequate amounts of capital are set against such loans.

⁷³ Indeed, as noted above, market value would become more useful once comparison to long-term value was possible.

⁷⁴ For example, interest-cover ratios, debt yields and the present value of in-place cash flows as a proportion of the debt outstanding. More qualitative judgments about the strategy and skills of the borrower or asset manager should also be taken into account.

⁷⁵ The weaknesses of past and present capital regimes in this respect are discussed above, in Section 2.2 (Incentives).

⁷⁶ Currently, UK banks' implementation of slotting is understood to use market value based LTV as an input. However, it is worth noting that European regulators are showing interest in the greater use of some kind of 'mortgage lending value' for the purposes of Europe's implementation of Basel III. This mortgage lending value concept, which is likely to have important features in common with our proposed long-term value concept, may also be reflected in forthcoming European Banking Authority regulatory technical standards for the criteria to be used for slotting.

⁷⁷ As regards what amount of capital is adequate, the regulator would determine how to calibrate regulatory capital requirements having regard to its assessment of an acceptable level of overall financial stability risk. That might for example be based on a determination that state equity support for SIFIs should only be required in, say, one in ten CRE market crashes, and in only one third of those cases should the required level of state support in respect of CRE lending exceed a specified amount. In arriving at its determination of such risk thresholds, the regulator would weigh the continuous benefits to the economy of finance for the CRE market against the risk and cost of occasional state support. Having determined the optimal level of desired risk, the regulator could calibrate the regulatory capital requirements using data on CRE market crashes derived from existing sources and analyses and the emerging and increasingly rich dataset resulting from the implementation of Recommendation 1.

Scope of this Recommendation in relation to regulatory capital: The use of a long-term value concept as a risk management input should be valuable for all types of CRE lender (and Recommendation 1 should be implemented so as to capture long-term value for all CRE loans, allowing the regulator to assess overall market risk). However, the core medium-term objective of building long-term value into the regulatory capital framework is only relevant for lenders that are subject to risk-based regulatory capital rules by reference to the way they apply their capital.⁷⁸

LTV caps to be avoided: Any regulatory approach that operates by reference to market value based LTVs is flawed because of the inherently and inescapably pro-cyclical behaviour of market values. A separate question is whether high (even long-term value based) LTV lending should be banned altogether, rather than being a determinant for the calibration of capital requirements. The strong recommendation of the Group is against the use of outright LTV caps, because they are more constraining than is required to protect financial stability, without providing any additional protection, and with a risk of unintended consequences. A regime that gradually increases the regulatory capital requirement as long-term value based LTVs exceed specified thresholds is greatly to be preferred.

Practical considerations in linking long-term value to regulatory capital: It is worth discussing a number of practical aspects of incorporating a new long-term value concept into regulatory capital rules.

- **Staged implementation:** It would be inappropriate to link regulatory capital to a new long-term value concept before it has been tried and tested. Data and experience would help improve the concept once it is in use.⁷⁹ Over time (probably a number of years), it would earn the confidence of industry and regulators. In the interim, as confidence in the long-term value metric grew, regulators could include regulated lenders' adoption and use of it in their assessment of the quality of their risk management. The Group would support such staged implementation, building from initial rollout of a long-term value concept, through its refinement, to its eventual incorporation into the regulatory capital framework for CRE debt.
- **Incorporating long-term value based LTV into a governor-based regulatory framework:** Regulatory capital rules could be calibrated (having regard to the comments made in footnote 77) to incorporate long-term value in a variety of different ways. There are choices to be made as to: how long-term value itself is calculated and the point in the cycle it seeks to reference (for example, a cycle mid-point or low-point); the long-term value based LTV percentages at which risk capital requirements change; the weighting of long-term value based LTV in the overall determination of regulatory capital requirements; and the actual risk weights applied. The Group would like to see the adoption of an approach that operates relatively smoothly and consistently throughout the whole cycle, without the need for frequent judgment-based intervention.⁸⁰
- **Cost of using long-term value to assess CRE lending risk:** A regulatory requirement for valuation of collateral on long-term value principles would add to the cost of CRE lending by regulated lenders, particularly on the basis that this would be an additional valuation and not a replacement for market value valuation. However, the cost of such additional valuations should not be high once an appropriate methodology is developed. Furthermore, the ability to use the loan database contemplated by Recommendation 1 as an information source for valuations should offer useful synergies and savings as part of a better overall information environment. In any event, the Group believes that the cost should be justified by the benefits long-term value can unlock: a counter-cyclical regulatory regime, better cycle and risk information, improved financial stability and a sustainable flow of credit to CRE across the cycle.

⁷⁸ See the discussion about the scope of regulatory capital regimes in Section 2.2 (Incentives).

⁷⁹ There should be scope for meaningful synergies between the creation of the loan database proposed by Recommendation 1 and the development of the long-term value concept.

⁸⁰ This would be consistent with the aims of Recommendation 5 and Recommendation 7 to provide a reasonable degree of regulatory certainty for market participants.

- **Long-term value based LTV should not be the only determinant of regulatory capital:** The development and use of long-term value is not a complete solution to understanding and managing CRE lending risk and the danger it can pose to financial stability. A number of different factors should be taken into account by a debt investor, as they should by an equity investor, in CRE.⁸¹ The Group is not recommending that the regulatory capital requirement for CRE loans should be set solely by reference to long-term value based LTV. However, we believe that long-term value based LTV should carry a high weighting in any regulatory capital regime (perhaps increasing during an initial calibration period).

Using long-term value after a crash: It is normal that the risk appetite of lenders who over-extended (and regulators who were perhaps too relaxed) in the boom evaporates after the crash. That outcome is exaggerated by the use of market value based LTV as a risk management and decision-making tool. Long-term value could act as an automated counter-cyclical influence at this point of the cycle too, assisting both the property market and the economy at a time when credit is tight, because the information it provides should encourage prudent and sustainable lending after a crash.⁸²

Recommendation 5 (Better risk differentiation in regulatory capital requirements)

The basis for regulatory capital requirements should more accurately reflect the actual level of risk arising from CRE loans, with greater differentiation of capital requirements between loans with different risks. Very low-risk CRE lending (even if unrated) should be recognised as such for banks, including through the terms on which such loans may be used as collateral at the Bank of England.

AIMS

To remove the disincentive for UK banks and other lenders subject to regulatory capital requirements to advance low-risk CRE loans, and to discourage higher-risk loans appropriately.

To encourage regulated lenders to conduct prudent and responsible CRE lending supportive of investment, in particular after a CRE market crash.

To ensure that regulatory incentives for CRE lending by regulated UK lenders are adequately aligned with actual economic risk (having regard to financial stability considerations).

To reduce the risk of distortion and capital misallocation that arises when similar risks in CRE lending and other lending are treated in very different ways by regulatory capital rules.

To allow non-SIFIs to enter the CRE finance market at prices that are both competitive and reflective of risk, insofar as capital charges on riskier loans by regulated lenders can reasonably be set at levels that offset the competitive advantage conferred on such lenders by the lower cost of funds that implicit government support allows them to enjoy.

⁸¹ Quite aside from the other cash flow based metrics mentioned above, the complexity of CRE debt exposure is recognised in the criteria UK regulated banks have to take into account for slotting: financial strength, political and legal environment, transaction and/or asset characteristics, strength of the sponsor or developer and security package. See BIPRU 4.5.6R (<http://fs handbook.info/FS/html/handbook/BIPRU/4/5>).

⁸² Consideration would have to be given to the operation of regulatory capital requirements during a crash. If during the boom capital requirements were designed to provide adequate capital for a specific severity of crash and/or a level of maximum central bank support for SIFIs following a crash of a specific severity (see footnote 77), there would be a case for raising capital requirements in the event of a crash that threatened to exceed that which had been anticipated. That could be achieved by using a system of dynamically adjusted regulatory capital requirements linked to stable long-term value based LTVs. The operation of such a system could be prescribed in advance to ensure regulatory predictability through the cycle. In any case, the dynamic adjustment would be much less severe than that required when lending risk and capital requirements are determined by reference to market value based LTVs.

DISCUSSION

Regulatory capital should be aligned with economic risk: Each CRE loan is unique (like the underlying real estate) and carries a specific level of risk. A core objective of regulatory capital rules is to ensure that regulated lenders have adequate capital to withstand a crash. Accordingly, the risk weight attaching to a loan should seek to reflect the actual risk on that loan. A regulatory regime (such as slotting, with its five slots)⁸³ that is not capable of aligning with reasonably robust assessments of economic risk will not help in protecting financial stability after a crash. On the contrary, such a regime is likely to distort and potentially damage economic growth by discouraging sensibly priced credit to real estate businesses. It may even create unintended risks to financial stability, if regulatory arbitrage displaces economic risk management as an influencer of lending strategies and decisions.⁸⁴

Assessing risk on CRE loans: While CRE lending can be very risky, particularly in the feverish atmosphere of a boom, it can also be very safe, particularly where the features of the loan, the collateral and the cash flows are favourable. Defining a formula to measure the safety of all loans reliably is very difficult, due to the fundamentally heterogeneous nature of CRE and the varying weighting one should give to different characteristics when comparing loans. There must always be a judgmental element based on consideration of all the relevant information. However, LTV based on long-term value provides a very good starting point.⁸⁵

Very safe CRE loans should be encouraged: Given the very safe nature of certain CRE loans and the economic benefits deriving from an active CRE sector, it is important that such lending is actively encouraged. Such encouragement would ensure that there was an appropriate cost (and therefore pricing) differential between very safe CRE lending and riskier CRE lending by regulated lenders. It would help focus UK SIFI CRE exposure at the safer end of the spectrum, allowing greater diversity and competition in the rest of the market (where the risks to financial stability of market dominance by UK SIFIs would be greater).⁸⁶ It should also encourage responsible lending in the challenging period following a CRE market crash. That would provide some of the liquidity needed to refinance legacy loans as well as keeping credit flowing when the sector and the economy need it most.

- **Market encouragement:** In principle, the market should reward the attractiveness of very safe CRE loans through a liquid secondary market.⁸⁷ A number of factors have inhibited such a development – and should be countered by the recommendations in this Report.⁸⁸ Secondary market liquidity could also play an important role in unlocking the potential for longer duration CRE lending, facilitating valuable diversification and market resilience.⁸⁹

⁸³ See the discussion of past and present capital regimes for CRE lending in Section 2.2 (Incentives).

⁸⁴ For example, if two safe loans present a similar aggregate risk of loss as a single higher risk loan but regulation imposes a significantly higher aggregate capital charge on the two safe loans than on the single higher risk loan, a rational regulated lender is likely to prefer to make the higher risk loan.

⁸⁵ As explained in the discussion of Recommendation 4, long-term value is a much better basis than market value for determining LTV for these purposes, because market value is highly cyclical. Long-term value places a greater emphasis on a property's cash flows, disregarding the market's cyclically volatile perception of what capitalisation rate should be applied to those cash flows.

⁸⁶ As a practical matter, the UK clearing banks are likely to remain the main originators of CRE loans, particularly in regional markets and at smaller ticket sizes, where their local presence and infrastructure cannot easily be matched by other market participants (existing or new). However, it does not follow that all risk associated with such origination should remain on their balance sheets.

⁸⁷ Ideally, there should be a liquid market in CRE loans with a range of different risk profiles – either directly or through capital markets instruments. This point is discussed further in the context of Recommendation 6, but the case for liquidity in very safe CRE loans is particularly strong. Such loans are the ones most appropriate for non-specialist investors. Suitably defined, they should not be affected by the problems with underwriting quality and poor investor information that the GFC laid bare in much of the market in repackaged property loans (residential as well as commercial, in the US as well as in the UK and Europe).

⁸⁸ Better market information and transparency (Recommendation 1) would facilitate the emergence of a universally recognised mechanism for identifying such loans. A more educated market (Recommendation 3) would better understand their characteristics and the importance of maintaining a brand for safe CRE loan. This Recommendation could encourage the emergence of instruments free from the complexity, lack of transparency and due diligence challenges that plagued CMBS in the past. Perhaps most importantly, the market would be helped by the stability and certainty engendered by a regulatory environment consciously designed to work across the cycle. That is a central goal of this Report, elaborated in the discussion of Recommendation 7. It would also be helpful if the regulatory environment specifically recognised very safe CRE loans as such (this Recommendation). Broader regulatory initiatives to adjust individual incentives and improve alignment of interests between originators and investors should also help.

⁸⁹ See Recommendation 6.

SECTION 2: RECOMMENDATIONS

- **Regulatory encouragement:** There are at least three direct ways in which the regulator could incentivise very safe CRE lending as an important element of the wider financial market.
 - The first is the central element of this recommendation: to set capital requirements applicable to those originating the very safest loans at a level that recognises the very low risk of loss of such loans.
 - The second is to ensure that regulatory capital rules applicable to potential investors in (as distinct from originators of) such loans, and bonds backed solely by such loans, recognise their very low risk in the hands of such potential investors.
 - The third is for such loans and bonds to be accepted as eligible collateral in the Bank of England's discount window facility (DWF), regardless of whether they are rated, on a basis that reflects their credit strength.⁹⁰

Practical challenges in implementing risk differentiation: In the near term, the UK regulator does not have a completely free hand to implement this recommendation, because regulatory capital rules are largely set internationally. However, there are at least two ways in which the UK might promote better CRE lending risk differentiation in its regulatory capital rules.

(a) **Development of better internal ratings-based (IRB) models:** Two key problems with IRB models for CRE finance in the UK in the past appear to have been the poor quality of data and analysis available to support them, and poor communication and trust between banks and their regulator.⁹¹ The carrot of IRB model approval should encourage industry adoption of the principles underpinning the vision outlined in this Report.

(b) **Sectoral and counter-cyclical capital buffers:** In the meantime, the Bank of England and the Prudential Regulation Authority (PRA) should use their powers to apply sectoral and counter-cyclical capital buffers to support greater differentiation between the safer and riskier ends of the CRE finance spectrum (in line with economic risk, and in a way that slotting cannot accommodate). Those powers should be used to promote sensible provision of credit after a crash, when risk is lowest, as well as to discourage excessive supply and risk in CRE finance when the market is overheating.

2.3 A market structured for stability

The use of long-term value based LTV in determining regulatory capital requirements for CRE loans should make a valuable contribution to moderating the extremes of the real estate cycle. Combined with risk differentiation, better training and reward systems and, particularly, regulatory encouragement for very safe CRE lending, it should both dampen excessive exuberance near the top of the cycle, and keep credit flowing at the bottom of the cycle.⁹² However, more can and should be done to build stability and resilience into the CRE finance market. This section introduces two recommendations⁹³ designed to do that.

Resilience through diversity: The CRE finance market would benefit from a structural shift to greater diversity in terms of lender response, so that different CRE lenders behave in different ways at different points in the cycle. The market will also be more resilient if it contains a better balance of CRE debt supply, for example between shorter-term and longer-term, floating rate and fixed rate, balance sheet and intermediated. A more balanced market should lead to greater diversity of response to market signals. For example, the withdrawal of banks following a crash should not result in a complete credit drought; ideally,

⁹⁰ This particular suggestion is limited to banks. The Group is aware that there has been discussion regarding use of the DWF by organisations not subject to banking regulation, but has no considered view on that question.

⁹¹ Poor incentive structures and cultural factors within institutions may also have contributed, but these are not issues intrinsic to IRB models. Over time, Recommendations 1-3 should all help to address both of the problems identified above.

⁹² Recommendations 4 and 5 are designed to achieve these objectives.

⁹³ Recommendations 6 and 7.

other lenders should be available to support CRE transactions. An undiversified market should ring alarm bells even aside from financial stability considerations, as it indicates that one lender type may have too strong a competitive position (potentially due to regulatory distortion or arbitrage), with others being crowded out. Market concentration could be linked to banks using cheap short-term funding, shadow banks benefiting from an excessive regulatory advantage over traditional bank lenders, or overseas lenders sitting outside the UK's regulatory perimeter (and with little long-term commitment to the UK market).

Diversity through secondary markets: A certain amount of infrastructure is required for a CRE loan origination business. While the UK banks' local branch networks provide that, few other CRE lenders are likely to be able to justify the cost of an origination business other than for large loans in central locations.⁹⁴ Achieving meaningful diversification therefore almost inevitably requires the existence of effective avenues for investors to gain exposure to CRE debt originated by others. To some extent, that can happen through partnerships or joint ventures between end investors and originators. A true secondary CRE debt market in which existing investments can be traded could play an even more important role. A degree of standardisation and transparency at the loan level could stimulate the growth of such secondary markets. The effect should be to disperse risk that would otherwise remain concentrated in the hands of a relatively small number of banks, and more efficiently to match borrowers with non-originating lenders.⁹⁵

Stable, governor-based regulation: In parallel, the regulatory system needs a cultural redesign to shake off its cyclical character. Periodic swings between light touch and heavy-handed regulation should be replaced by a framework built to work across the cycle, based on graduated, counter-cyclical regulatory governors rather than on/off switches. Such a system would replace a typically pro-cyclical regulatory environment with a more stable, counter-cyclical one. It would also improve certainty and market participants' confidence in the regulatory system.

Recommendation 6 (Encouraging diversity)

The regulator's function should reflect the important role that can be played in promoting financial system resilience and stability by diversity of lender response (principally through diversity of lender types and lender strategies, and with a focus on the role secondary markets can play). Where possible, regulatory action should have regard to levels of diversity and seek to reduce barriers to entry, particularly for new or under-represented types of lender.

AIMS

To protect market stability from a change in strategy by any individual or group of lenders.

To encourage a regulatory focus on the composition of the CRE lending market (in terms of both originators and end investors), which can act as an additional indicator as to the state of the market and the drivers of participation in that market of different types of lender.

⁹⁴ Many large insurers, for example, have set up origination platforms, but they generally restrict their activities to large urban centres and loans of at least tens of millions of pounds in size.

⁹⁵ The pure 'originate to distribute' model that evolved during the boom leading up to the GFC did not meet these conditions, in large measure because of inadequate transparency, as well as poor institutional and individual incentives resulting in poor alignment of interests between originators and end investors. However, that history does not undermine the potential benefits of effective secondary CRE debt markets.

DISCUSSION

Lack of diversity: An undesirable feedback loop arises when CRE loan market participants respond to market signals in the same way, either because the market is dominated by a handful of players, or because similarly funded, structured or regulated market participants act in a herd-like manner. For example, if most of the market reacts to stress by swiftly curtailing CRE lending, that adversely affects values, restricts the availability of capital for refinancing existing loans and reduces liquidity in the CRE sector. Stress on existing CRE loan portfolios is thereby increased, and CRE lender balance sheets suffer and (pro-cyclically designed) regulatory capital costs go up. The result is likely to be higher losses on CRE loans, which may be exacerbated by particular features of the market (for example, funding mismatches or a maturity cliff at the wrong time affecting much of the market).⁹⁶

Diversity of CRE lender response: The objective of diversity is that the market should be composed of lenders who will respond to market and cycle signals (including overheating and a crash) in different ways. By 'lender' we do not refer simply to the person who advances a loan, but rather to those who can exercise influence over (a) the characteristics of the loan (such as its term or whether it has a fixed or floating rate); and (b) the response to market and cycle signals (expressed for example through willingness to provide capital or willingness to support borrowers under stress). So the lender may be a bank (or an insurer) that advances loans and holds them on its balance sheet to maturity, or it may be investors investing in a CRE debt fund whose investment policy they can influence or negotiate, or it may be influential investors in CMBS or other CRE bond products. Lender response may be diverse even when the capital is from the same source, if capital allocations are made or loans advanced with different criteria and investment objectives. Regulation can encourage or discourage this kind of diversification.

Market context: Diversity of lender response may take differing forms, and may not always be obvious – but it is a key feature of resilient (if not necessarily stable) markets. Germany's CRE loan origination market is relatively homogeneous, dominated by domestic banks. However, it benefits from structurally low levels of volatility in the underlying CRE market, and from the cheap, liquid and long-term refinancing for the lower risk slice of CRE debt provided by the Pfandbriefe covered bond market.⁹⁷ At least in theory, that allows non-bank end investors to influence the characteristics and behaviour of a substantial part of the CRE debt market, insofar as that market has to fit with the bonds they are prepared to buy. The US market, by contrast, is much more obviously diverse, with a much greater role for the capital markets and long-term fixed-rate finance provided directly by institutions, and a more limited role (other than as originators) for banks. That diversity did not prevent the tumultuous real estate debt-related collapse of 2007 and 2008, but it almost certainly contributed to the speed with which the US market was able to recover. The Group is convinced that resilience would be greatly enhanced by more diversity in the UK's liquid, transparent, internationally open (and therefore inherently volatile) CRE market.

Other kinds of diversity: A market may appear to be diverse while in fact being merely segmented.⁹⁸ Diversity may be cyclical rather than structural, and it can be unclear whether changes in market composition provide positive diversity. Less knowledgeable new entrants bringing more capital into an overheating market can add to competitive pressures among lenders and drive down the quality of underwriting, even as they make the market more diverse. On the other hand, knowledgeable long-term market participants might withdraw from an overheating market because they can no longer compete on a viable basis, reducing diversity (temporarily and counter-cyclically) through that healthy and desirable response. A diverse universe of CRE equity investors can also enhance resilience, particularly if it includes a

⁹⁶ A major factor is forced sales of CRE debt into a distressed and illiquid market. These problems could be mitigated if regulators provided a liquidity backstop through the DWF and encouraged greater secondary market liquidity in CRE debt more generally, as proposed in the discussion of Recommendation 5.

⁹⁷ See the discussion of Recommendation 4 and specifically footnote 70.

⁹⁸ For example, overseas lenders might dominate prime central London property, UK institutions might dominate good secondary property, and UK banks may be the only lenders to the rest of the market. Such diversity would deliver limited benefits and could present threats to the CRE market and financial stability.

substantial element with long-term investment horizons, a focus on income rather than capital growth, and modest reliance on leverage.⁹⁹

Monitoring diversity: The regulator should have good information and a good understanding of the sources (as well as of the flow and stock) of both equity and debt capital into the CRE sector throughout the cycle.¹⁰⁰ The regulator should seek to use its knowledge to encourage (not mandate) genuine diversification of lender response so that credit remains available even in times of stress. That would support liquidity and investment activity for the benefit of lenders wishing to reduce their exposure, as well as providing some support for the CRE market itself.

Regulating for diversity: Regulatory differences will often play a role in the participation levels of different types of lender, so there should be tools available to the regulator to enable it to encourage or discourage particular lender type participation in the CRE lending market.¹⁰¹ The Group recognises that it may not be easy for the regulator to ‘encourage’ changes in the composition of a market. That is especially true when only certain parts of that market fall within the regulatory perimeter, and those parts (banks, insurers, shadow banking) are subject to different regulatory regimes and supervised by different teams at the regulator. The holistic sector-focused perspective advocated by this Report should encourage better communication across teams, and more effective use of regulatory differentiation to promote financial stability and a well-functioning and diverse market. The related suggestions that follow seek to identify specific areas of focus for assessing, and encouraging, diversity.

Diversification by loan duration: Given the long-term nature of CRE as an asset class, a more substantial element of long-term CRE lending in the market would reduce the threat to financial stability posed by refinancing risk. Such diversification in the CRE debt products in the market should also lead to greater diversity of lender response, enhancing market resilience. It is worth considering this in turn from the point of view of the lending market (as it is, and as it might evolve), and from the borrower’s perspective:

- The CRE lending market remains, for the present, dominated by banks. Banks are strongly incentivised by current and incoming regulatory regimes to lend at shorter durations, and that is reflected in their preference for lending at terms not exceeding five years. A key function of banks – which also presents risks to the financial system – is maturity transformation, matching short-term liabilities (such as deposits or commercial paper) with long-term assets (such as fixed-term loans). The wider the gap between the duration of banks’ funding base and the duration of the loans they write, the greater the risk of liquidity stress, as the funding base can contract much more quickly than loans can be liquidated. It is uncertain whether the current regulatory regime strikes the right balance between allowing banks to have an optimally diversified asset base (including by duration, to manage maturity cliff risk) and discouraging excessive liquidity risk through funding mismatch risk.
- There are, however, alternative institutional sources of finance for which long-term CRE debt exposure is attractive without giving rise to funding mismatches. For insurers with long-term liabilities, holding long-term CRE debt can be attractive. They can gain such exposure either by originating such loans themselves, or by acquiring (directly or through bond products) exposure to loans originated by others. For many insurers, building or acquiring a platform to originate long-term CRE loans is unlikely to be practically or financially feasible, except perhaps for large loans. The emergence of effective and reliable market mechanisms to allow bank-originated debt to be reliably distributed to non-bank institutional investors may be necessary if duration and lender diversification are to benefit regional and smaller ticket parts of the UK CRE market.¹⁰² Regulation should seek to facilitate the development of such market mechanisms.¹⁰³

⁹⁹ Notwithstanding its relevance to financial stability, the composition of the CRE equity investment market would not be easy to influence in an open economy like the UK. This Report therefore focuses on the composition of, and diversity in, the CRE debt market.

¹⁰⁰ Recommendations 1 and 2 should assist in this regard.

¹⁰¹ Essentially, the regulator needs to be aware of the relative regulatory treatment of different types of potential participant in the CRE debt market (this is the flip side of arbitrage risk, mentioned in the discussion of Institutional incentives in Section 2.2 (Incentives)).

¹⁰² See also the discussion of the regional and small loans challenge below in this section.

¹⁰³ See also the discussion of Recommendation 5 for more about the role of regulation – and how different strands of regulation fit together – in encouraging desirable market developments.

SECTION 2: RECOMMENDATIONS

- The other key question is the extent of borrower demand for long-term CRE debt. There are plainly CRE investors large and small with long-term hold strategies for whom long-term loans would be attractive were they more accessible. However, there is also evidence that many UK CRE borrowers value the flexibility of being able to prepay a loan without significant penalties when they sell the asset on which it is secured. Short-term loans generally have lower potential prepayment penalties as the duration of the interest rate fixing is short. Institutions seeking to match asset and liability maturities over a longer period generally require make-whole provisions that translate into higher prepayment penalties for borrowers. For much of the CRE market, long-term loans with prepayment penalties would impose unacceptable constraints on commercial flexibility.
- A solution, for some cases at least, may be to facilitate the cheap and simple transfer of a loan by a borrower to the entity to which the borrower sells the asset on which the loan is secured. The challenges this solution presents for the lender will depend on the extent to which the quality of the borrower, as distinct from the asset, was key to the decision to lend or invest. It may be simplest to achieve in the case of loans with a low risk of loss.¹⁰⁴

The regional and small loans challenge: One of the greatest challenges in promoting diversity is the market for CRE lending to smaller businesses and against smaller assets, especially outside the principal markets of London and a handful of other major centres.

- Unlike prime UK CRE, which generally enjoys considerable financing diversity, the regional and small loans market is overwhelmingly dominated by the UK clearing banks. This situation is only partly due to the centralised economic and political structure of the UK; other kinds of lenders lack the regional infrastructure to support an origination platform for small ticket CRE debt nationally.
- The lack of substantial interest from institutional and international sources of equity and debt has created structural problems in the regional and small loans market. The limited debt investor base is reflected in a limited range of offered products (principally, short-term bank debt).¹⁰⁵ That would tend to increase the cost of credit in the regions and for SMEs, adding an additional burden to the competitive challenges they face.
- Regional lending is vulnerable to poorer quality underwriting (with pricing not always reflecting the probability of default and loss given default). Poor CRE market expertise among relevant decision makers at lending institutions may be one reason for this.
- As a result, it suffers particularly acute alternating credit floods and droughts (as the cyclical impact of lenders other than UK banks entering and leaving this part of the market is particularly dramatic given the the limited range of lenders reliably participating in the market).

Addressing the regional and small loans challenge: Better loan and collateral data¹⁰⁶ and education,¹⁰⁷ coupled with better calibrated regulatory capital rules,¹⁰⁸ should improve consistency in lending terms, and the quality of lending and pricing. That in turn should make CRE debt aggregation easier, unlocking institutional sources of capital that require scale as well as better quality control. Regulatory encouragement for secondary market liquidity (including through a new improved generation of CMBS and/or other capital markets instruments) would help by promoting greater diversity in the sources of capital and thus in the products available.¹⁰⁹ Over time, we may see a broader range of financial intermediaries compete with dominant UK banks for origination business.

¹⁰⁴ If transferability were free only for very safe loans (see Recommendation 5), that would serve to incentivise parts of the borrower universe to drive the growth of more responsible CRE finance, complementing the suggestions in Section 2.2(Incentives) for Incentives for borrowers.

¹⁰⁵ CRE lending by banks is also largely floating rate, with interest rate protection provided through separate hedging instruments. The terms of which such hedging was sometimes provided in the last boom have proved contentious, with some arguing they represented an additional source of risk that was not always understood.

¹⁰⁶ Recommendation 1.

¹⁰⁷ Recommendation 3.

¹⁰⁸ Recommendations 4 and 5.

¹⁰⁹ A specific aim of this Recommendation.

The American model: The US offers the most direct indication of what a more diverse market might look like. Having regard to the US experience, there may be merit in considering the following for the UK:

- **Encouraging the emergence of specialist CRE lenders:** This would improve transparency in the capital investment market and help to distribute CRE risk away from SIFIs, provided there were limitations on the use of leverage by such entities.¹¹⁰ Investors wanting exposure to CRE debt without necessarily having the scale or the expertise to lend directly would have somewhere to go outside the systemically important and very complex banking sector. Specialist CRE debt investors should be permitted to both acquire CRE debt originated by others and originate CRE debt themselves.
- **Encouraging fixed-rate lending:** The overwhelming reliance of the UK market on floating-rate bank debt created a need for interest rate hedging products. Some parts of the market in such products became complex and opaque, with hedging instruments sometimes delivering benefits, and containing risks, beyond mere interest rate hedging. One manifestation of this during the GFC was inappropriately long-dated,¹¹¹ out-of-the-money hedges which greatly complicated the refinancing or restructuring of CRE loans. Other markets, including the US, benefit from substantial participation by fixed-rate lenders such as insurers alongside largely floating-rate debt from banks.
- **Sensitive shadow banking regulation:** If non-traditional lenders are to be encouraged to enter the CRE lending market, the regulatory framework applicable to them must be proportionate and appropriately targeted. This Report recommends imposing certain requirements on such lenders,¹¹² but a holistic view of the CRE finance market does not mean ‘one size fits all’ regulation. Capital requirements for systemically important institutions such as banks can offset the competitive advantage conferred on banks by their low cost of funds, as well as incentivising financial stability. That can create space for non-systemically important lenders (which do not need to be subject to such capital requirements) to compete.
- **Promoting secondary CRE debt market liquidity:** The industry should be encouraged to develop best practice standards and transparency in CRE lending – especially, perhaps, at the safe end of the spectrum.¹¹³ Coupled with improved incentives for originators and better alignment of interests with non-originating investors, that should help build the sort of secondary market liquidity that America enjoys. A secondary market – whether in bonds or in loans – should in turn promote diversity of lender response, as well as ensuring that the financial system does a better job of connecting investors seeking CRE risk and returns with CRE businesses wishing to borrow.

¹¹⁰ In the US market, the real estate investment trust (REIT) regime accommodates such entities, providing regulatory encouragement through the tax benefits that go with REIT status. However, the US regime imposes no leverage restrictions on such entities, and their sometimes substantial use of leverage can make their performance volatile, as well as giving rise to significant shadow banking risks. The Group is not recommending a straight ‘copy and paste’ of the US rules in this area to the UK.

¹¹¹ Interest rate hedging beyond the term of a loan can be appropriate, for example, where the borrower intends to hold the property and is confident that refinancing risk can be managed at the end of the loan term.

¹¹² Most importantly Recommendations 1-3.

¹¹³ One of the strengths of the Pfandbriefe market in Germany is the fact that only the low risk slice of any potentially qualifying loan is eligible. Creating liquidity is easier if there is quality control for the product.

Recommendation 7 (Regulatory governors, not switches, operating consistently across the cycle)

Regulators should use regulatory governors (including the application of sectoral and counter-cyclical capital buffers) that increasingly restrain regulated lenders as the CRE market rises above its full cycle average, irrespective of views about whether a CRE market crash is anticipated or considered unlikely. An explanation should be required where the regulator wishes to override that framework.

AIMS

To ensure the economy is positioned to manage a CRE market crash at any time when objective criteria indicate that one is possible, irrespective of subjective perceptions of its likelihood or imminence.

To create a regulatory framework that can operate effectively across the cycle, with built-in counter-cyclical governors, limiting both the need and the temptation for cyclical regulatory intervention, and enhancing regulatory certainty for business.

To promote more effective flexing of existing regulatory capital requirements in a consistent and incremental way – not to introduce new, additional requirements.

DISCUSSION

Regulation that is consistent across the cycle: Breaking the link between cyclical markets and pro-cyclical regulatory responses is essential if we are to make the financial system more resilient and break the feedback loop between CRE lending and CRE market volatility. That is why so many of the Recommendations in this Report seek to promote a regulatory framework that is consistent across the cycle and sensitive to it, based on incremental intervention. A prerequisite for such a regulatory framework is good quality information and analysis.¹¹⁴

Predicting the next crash: Reliably predicting when a property market crash will happen is impossible. If a bubble is irrational overvaluation, there is no reliable, rational way to predict when it will burst. However, calling the top of the market is also a distraction.¹¹⁵ What matters is understanding which phase of the cycle the market is in so that incremental counter-cyclical measures can be applied to moderate the cycle and protect the financial system. Careful monitoring and analysis of relevant market data in real time is the key to determining when market values have moved above their whole-cycle average. That in turn allows the regulatory capital cost of CRE lending by banks and other SIFIs to be gradually increased, discouraging over-exuberant lending and building up the capital buffers required to withstand a correction.

Automatic governors, not on/off switches: This Report recommends a regulatory framework that automatically responds to market data by gradually turning a regulatory dial up or down. The Group considers that to be both more effective and less distortive of market behaviour than a regime that moves less predictably and more abruptly (for example by intervening occasionally to ban (or allow) particular behaviours or to subject them to limits or thresholds). The automated, incremental approach responds to mostly objective market data that is there for all to see, and it does not involve any implicit or explicit assertion as to the precise current state of the market (which could prompt the very crisis it seeks to avert).

¹¹⁴ Recommendations 1-3 are all directed at delivering.

¹¹⁵ A point that was also noted in the discussion of the expert advisory committee proposed in Recommendation 2.

Governor approach to regulatory capital: The calibration of capital requirements for regulated lenders is the most obvious and powerful governor available to the regulator.¹¹⁶ Further calibration can be designed by reference to relevant market data using the sectoral and, in particular, the counter-cyclical capital buffer available to the regulator under Basel III. Plainly, only regulated lenders can be directly influenced using capital requirements – but regulated lenders are a worthwhile target because of their systemic importance. Moreover, the indirect effect should be much broader, even if it is not entirely predictable. Reduced or more expensive lending by banks might dampen exuberance, or it might allow unregulated lenders to increase their market share, allowing some upward market pressure to persist. That need not be a problem if SIFI exposure is correspondingly limited to lower risk CRE lending; and this Report has also considered ways in which demand for CRE debt might be dampened.¹¹⁷

Automated governors, tempered with judgment: Without a doubt, an entirely automated regime populated solely by pre-configured governors would be inadequate. Even aside from the possibility of flaws in the design or lessons that might be learned along the way, there needs to be room for judgment-based regulatory consideration of and response to subjective or new information.¹¹⁸ However, there must be a meaningful ‘comply or explain’ regime for a regulator who wishes to intervene in a way that departs from the automated governors built into the system, particularly if the intervention is aligned with the market cycle. Otherwise, the danger is that the regime will be relaxed in a boom and tightened up after a crash, reviving a regulatory cycle that reinforces market cycles. In a boom, regulators are under the same kind of pressure as lenders: to avoid disturbing a situation in which everything appears to be going very well.¹¹⁹

The data: Determining and monitoring the long-term value of collateral allows comparison with its market value.¹²⁰ When market values rise above long-term value,¹²¹ the market and regulators can see that the cycle is moving into its exuberant phase. Various other metrics are reliably closely correlated to the CRE market cycle, such as the cost of CRE finance, the deployment of equity and debt capital into CRE, and tightening or relaxing financial covenants. Additional colour can be provided by more subjective considerations, such as the composition of the equity and debt CRE markets¹²² or the prevalence of financial innovation. Appendix 2 (Metrics for governors) offers some more specific suggestions.

¹¹⁶ See in particular Recommendation 4.

¹¹⁷ See the discussion about Incentives for borrowers in Section 2.2 (Incentives).

¹¹⁸ This point is specifically recognised by, and catered for, by Recommendation 2 and its proposal for an expert committee to support the regulator’s own expertise with market insight.

¹¹⁹ Among the many wise words written by JK Galbraith in his 1954 book, *The Great Crash 1929*, is the following comment about the predicament of the insightful regulator during a bubble: “A bubble can easily be punctured. But to incise it with a needle so that it subsides gradually is a task of no small delicacy. Among those who sensed what was happening in early 1929, there was some hope but no confidence that the boom could be made to subside. The real choice was between an immediate and deliberately engineered collapse and a more serious disaster later on. Someone would certainly be blamed for the ultimate collapse when it came. There was no question whatever as to who would be blamed should the boom be deliberately deflated.”

¹²⁰ See Recommendation 4 for a more detailed discussion about the importance of long-term value in understanding and managing CRE lending risk.

¹²¹ Assuming that long-term value is designed to reflect a mid-cycle value. However, even if long-term value is differently calibrated, the relationship market values bear to it will provide important information risk management information about where the market sits in the cycle.

¹²² As discussed in relation to Recommendation 6.

Appendix 1: CRE and CRE finance in the UK

A1.1 The CRE universe

This Appendix presents a brief overview of the UK CRE sector, its importance to the UK economy and the role debt plays in it. Much of it is drawn from a more detailed article on the subject of commercial property and financial stability published in a 2013 edition of the Bank of England's Quarterly Bulletin.¹²³

Size and ownership structure: ONS data suggests that CRE accounts for 25% of the UK capital stock, although measurement issues mean the true proportion may be much larger.¹²⁴ Of the UK's CRE, approximately one third is owner-occupied, with the balance owned and leased out to occupiers by investors who invest either directly or through collective investment vehicles.

Market segmentation: It is usual to refer to prime, secondary and (less commonly) tertiary property to segment the CRE universe by reference to quality or risk/return characteristics. These terms have no universally accepted definitions, but it may be useful to think of 'prime' as referring to large assets in select locations like London or to assets with strong, bond-like leases. Prime property is an attractive investment class for more conservative listed property companies and domestic and foreign institutions, and many domestic and foreign banks and institutions will lend against it. 'Secondary' (or 'good secondary') commonly refers to assets large enough or sufficiently well leased to be of interest to some institutional investors (and to a narrower range of lenders), generally offering higher returns at higher risk, than prime. The weakest category, sometimes termed 'tertiary', would comprise smaller, older and more challenging assets likely to interest only private investors and specialist funds, without institutional money underpinning values, and with only domestic banks willing to provide finance. Evolving cities, changing occupier needs and construction and environmental standards, and building lifecycles mean that individual buildings can move between categories.

Ownership of investment CRE: The major direct owners of investment CRE are domestic and overseas pension funds, insurance companies and other institutions including sovereign wealth funds, listed property companies, private firms and individuals. Institutional owners who are focused on reliable, long-term income returns generally tend to own lower risk, lower yielding prime property. Private or more entrepreneurial investors and specialist funds may focus more on capital growth potential, investing in riskier, higher yielding property with redevelopment or repositioning potential. Listed property companies and collective investment vehicles investing in CRE (CRE funds) pool capital, offering a broad range of investors the ability to invest in CRE on a diversified, relatively liquid and professionally managed basis. CRE funds can be listed or unlisted and open or closed ended. They may adopt any of a range of investment strategies, from low risk/return 'core' to higher risk/return 'opportunistic', as well as by reference to different functional or geographical sub-sectors, and the extent to which they undertake development activity.

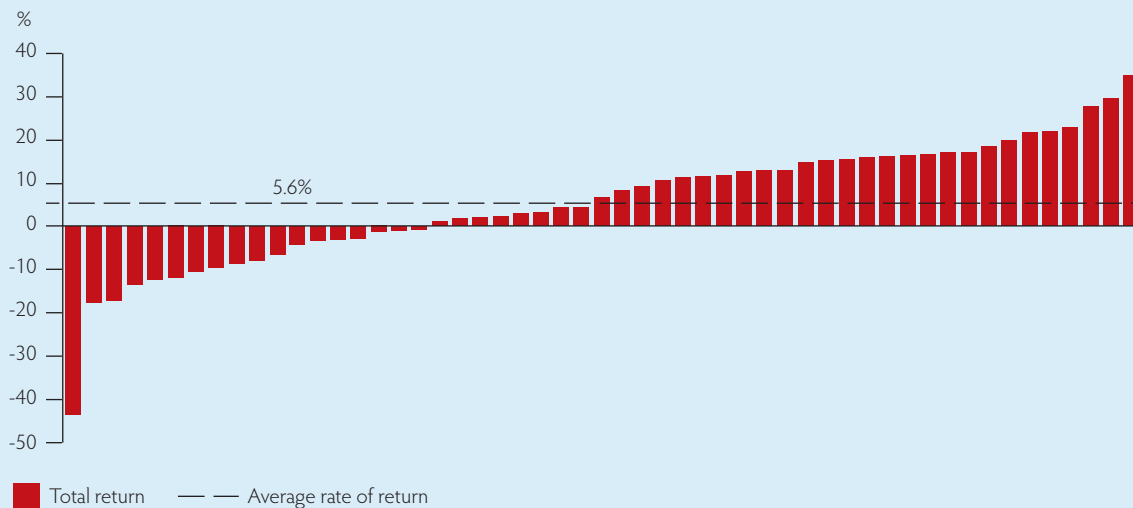
A fragmented market: Quite aside from the quality/risk segmentation of the CRE universe mentioned above, it is important to appreciate that CRE capital and rental values (in the UK as elsewhere) are highly asset-specific and determined in a jumble of sub-markets, many of which are uncompetitive, infrequently traded and informationally inefficient. National, 'all property' data offer limited insight into what is happening in the local market, but even granular average numbers for a particular area or sub-sector may say little about the characteristics of any individual asset contributing to those numbers (see Figure 9).

¹²³ See <http://www.bankofengland.co.uk/publications/Documents/quarterlybulletin/2013/qb130105.pdf>.

¹²⁴ ONS capital stock figures are based on depreciated historic cost rather than market value. More than for other components of the UK's capital stock, CRE depreciated historic cost and value differ markedly, largely due to the supply restrictions imposed by planning policy. It is likely that CRE would account for a much larger part of the capital stock if market value were used to measure the capital stock.

That is particularly the case in relation to regional and smaller-scale CRE, which may be off the radar of the institutional investors whose decisions are a significant influencer of capital flows and liquidity. Such markets are particularly likely to suffer from limited transactional activity and valuation information. They are also vulnerable to pronounced credit drought in challenging economic times, when confidence and risk appetite are low and investors and lenders generally become more cautious and selective.

Figure 9: **Retail in Edinburgh – spread of annual total returns from 53 individual units in 2009**



Sources: Fidelity International; IPD UK December 2009

CRE’s contribution to the economy: Estimates of the proportion of gross domestic product (GDP), gross value added (GVA) and employment attributable to CRE vary considerably. There is no single authoritative source of information or any single agreed approach to defining the CRE sector and measuring its contribution.

A1.2 Importance of CRE for the wider economy

Rental market: A healthy investment market in CRE provides essential liquidity and flexibility for businesses in the form of the ability to rent space, albeit the contribution that makes to productivity is difficult to measure. A flexible rental market helps existing firms expand and shrink capacity and relocate in response to changing opportunities in different geographies without large fixed costs. It also enables new enterprises to start operating and improve overall productivity by displacing less productive existing firms. The ability to rent commercial space amounts to a vitally important quasi-financial service to business by the CRE industry, particularly benefiting SMEs, for which building or acquiring their own premises would be very costly and inefficient. Being able to rent suitable premises allows ordinary businesses to deploy their capital in other, more productive ways, and avoid involuntary CRE market exposure.

Collateral for owner-occupiers: Some businesses choose to own their premises, gaining diversification benefits, protection from inflation, and the ability to control a building or site so as to restrict access for competitors and retain greater freedom to redevelop. For owner-occupiers, CRE also makes it easier to obtain finance. It is estimated that around 35% of large company debt and 45% of SME debt is secured on CRE. Lenders like using property as collateral as it provides a second line of defence against losses on the loan: if the borrower cannot pay interest and capital out of operating income, then the value of the collateral can protect against loss. For borrowers, giving security over their property increases the availability of finance (as lenders may be willing to lend with less due diligence of the borrower’s business) and reduces its cost (as lenders require less financial compensation, reflecting reduced lending risk).

A1.3 Debt and CRE

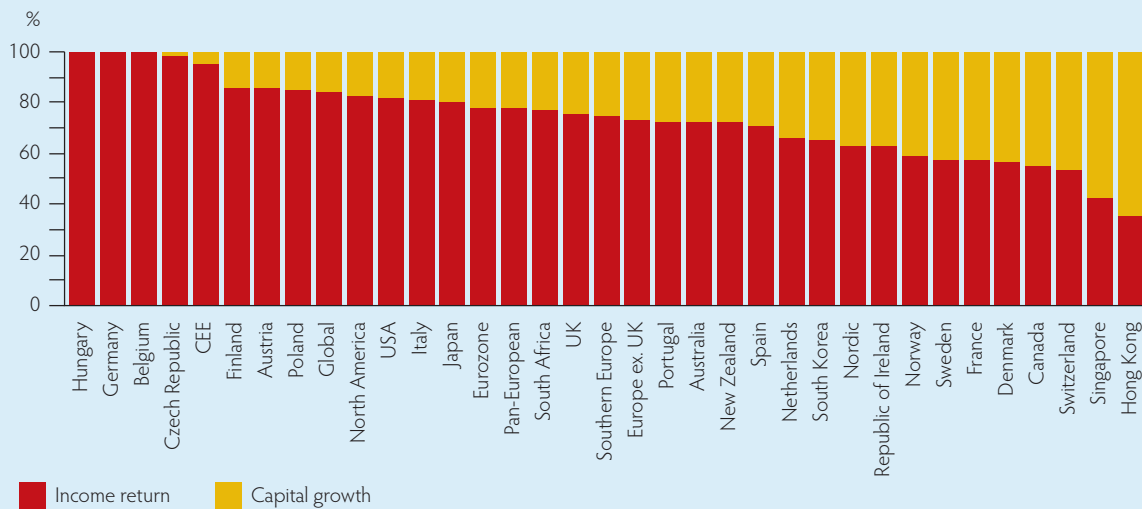
Role of debt in the CRE investment market: CRE investment is a capital-intensive business with a traditionally significant structural reliance on some element of debt finance. CRE is a depreciating asset class that requires periodic capital investment to maintain marketability for occupiers and investment value.¹²⁵ Capital investment may involve wholly new development, redevelopment, adaptation, extension or change of use, refurbishment or modernisation. It is often attractive for CRE businesses to pair equity capital (which demands a high return for the high risk it is willing to tolerate) with debt capital (which is content with lower returns because it takes less risk than the equity).

Debt or equity capital: Various commercial considerations – chiefly associated with the availability and relative cost of raising and holding different forms of capital – influence the extent to which a business will use debt. As a general matter, leverage amplifies risk and (up to a point) returns for the equity invested, because debt is generally a fixed cost, payable before equity returns. If the business fails to generate sufficient returns to meet debt costs, it will fail and the equity investment may be lost. On the other hand, after debt costs are met, all further returns represent a greater proportionate return on the equity invested. The differential tax treatment of debt (the cost of which is deductible) and equity (returns on which are not deductible) may incentivise some businesses to use more debt. Other businesses may balk at the risk, financial discipline and operational constraints which indebtedness entails.

Debt or equity capital in CRE: Choices around what kind of capital to raise are particularly important in capital intensive industries like CRE, and will play out in different ways depending on the context, as well as the strategy and preferences of the CRE business. The risk and return calculation, and the pricing of different kinds of capital, will be different depending on the underlying property and the borrower’s strategy.¹²⁶ Across the industry as a whole, there is generally an important place for debt, but the proportion varies greatly, depending on the owner and the asset, and at different times in the building’s lifecycle and the market cycle.

Investment asset class – equity: Its size as a sector and its characteristics as an investment also make CRE an important asset class for investors. It offers relatively stable and secure long-term returns (represented by rents and capital growth) while routing long-term savings into this important element of the economy’s capital stock. In mature markets like the UK, income typically accounts for more than 70% of the total return from CRE over the long term (see Figure 10). Income performance is also characterised by low volatility across the cycle. Capital growth, by contrast, is highly volatile.¹²⁷

Figure 10: **International long-term real estate returns – components of performance**



Sources: Fidelity International; IPD Multinational Index 2012; JLL/FIL Pan European Index 1981-2012; HK Rating & Valuation Dept 1988-2012; CBRE 2001-2012.

¹²⁵ This fact has important implications for lenders, not least for their exit valuations and thus for the development of a long-term value concept such as is proposed by Recommendation 4.

¹²⁶ For example, the asset may be a speculative or pre-let development project; or the borrower may be seeking to refurbish and/or reposition an asset which it already owns or is acquiring; or the borrower may simply be purchasing a stabilised, income-producing asset. Each of these scenarios will present a very different proposition for a prospective lender.

¹²⁷ This is demonstrated by Figure 8 in the discussion of Recommendation 4.

Investment asset class – debt: Within the broader CRE asset class, CRE debt represents a lower risk, lower return option for investors (alongside its function of providing CRE owners with the ability to leverage their own equity investment). The high volatility of capital returns (highlighted in the previous paragraph) means that lending is safer if advanced against income. Lending against development projects (which will not produce income while construction work is carried out) requires a specific skillset, delivering higher returns to reflect the greater risk as compared to lending against income-producing assets.

Supply of CRE debt and systemic risk: CRE lending can be conducted in a safe way based on a sound understanding of CRE asset, portfolio and market risks and appropriate terms and pricing – but it is not always conducted safely. Lenders (both traditional and new) can be attracted by the ease with which capital can be deployed in CRE debt and the apparent (but illusory) safety of lending into a rising CRE market. Limited barriers to entry and the perception that no specialist expertise is required can lead to substantial CRE finance entering the market with neither local market knowledge nor a proper portfolio level risk assessment. It is much easier for lenders to focus on lending volumes and required returns, which can be objectively assessed, than on risk, the assessment of which is more subjective. The effect is pro-cyclical, with excess liquidity and competition among lenders driving rising markets up and underwriting standards down. It is largely more bullish capitalisation rates, rather than actual earnings, that drive values up as the boom approaches its peak.

Banks' exposure greater than CRE book: A side effect of the use of CRE as collateral by non-CRE businesses is that it increases the systemic importance of CRE both to the banking system and to the economy as a whole. As CRE values rise, the equity of businesses in the wider economy increases, improving their access to credit. Conversely when values fall, access to credit is reduced, its cost increases, and the sustainability of existing debt (particularly in the short term) can be compromised.

Sources of CRE finance: Historically, the vast majority of CRE debt has been originated by UK, and to a lesser extent overseas, banks and building societies (see Figure 4 on page 21). Some of that debt was securitised into CMBS, potentially providing a relatively flexible and liquid way for other investors to gain exposure to CRE debt risk and returns in the secondary market. The fact that most non-bank sources of capital – even those with relevant expertise – lack the infrastructure to originate or service CRE debt themselves (particularly regionally and at smaller ticket sizes) means that a secondary market is important.¹²⁸ However, only to a limited extent did 'real money' investors invest in CRE debt through CMBS, and when the GFC began, banks found themselves holding the majority of UK CMBS exposure on their balance sheets. Insurers have directly provided around £30bn of the existing stock of CRE debt, and blue chip CRE businesses have raised some £10bn of debt privately in the bond markets. In addition, a small but growing amount of CRE debt is owned by specialist hedge or private equity debt funds that have either acquired that debt from traditional lenders or originated it themselves.

CRE debt and the cycle: At the market level, the amplifying effect of debt manifests itself through its pro-cyclical impact. Leveraged investment exacerbates swings in prices and amplifies booms and busts in real estate, in turn exacerbating banking crises. In recent UK history, substantial cyclical CRE lending by SIFs – helped by the persistently cyclical nature of regulatory responses – has often resulted in large banking system losses on CRE. More recently, there has been a structural shift to shorter-term CRE debt prompted by the regulatory framework applicable to banks, as well as the demand for operational flexibility from many CRE industry borrowers. As CRE lending volumes are highest in the few years before a crash, a market dominated by three- to five-year CRE lending is especially vulnerable to large-scale defaults when many loans mature at the worst point in the cycle.¹²⁹

¹²⁸ There are various ways of linking CRE borrowers to non-originating sources of CRE debt, including the loan syndication market, structured products, covered bonds (where a covered bond market exists) and CMBS. Only covered bonds and CMBS are designed to be genuinely tradeable investment products, but while CMBS have delivered that in the US, they have yet to do so in any reliable and meaningful way in the UK.

¹²⁹ It can be difficult, in such a scenario, to distinguish between stressed or defaulting loans where the difficulty is temporary and forbearance justified, and cases where the underlying fundamentals of the loan and collateral are weak and enforcement, sale or restructuring may be more appropriate.

Appendix 2: Metrics for governors

Metrics to help determine the phase of the CRE cycle

During its work, the Group considered what metrics might be used in the assessment, at any point in time, of the phase of the CRE cycle. This Appendix summarises the metrics it identified.

MACRO LENDING DATA

- UK CRE lending volumes (flow) by banks, insurers and pension funds and other sources.
- UK CRE lending volumes (stock):
 - as a proportion of total lending (by relevant lender type and in aggregate);
 - compared to historic levels (by relevant lender type and in aggregate); and
 - relative to GDP.

PROPERTY MARKET DATA

- Prime and secondary long-run average yields compared to current yields.
- The spread between prime and secondary yields over time.
- Prime and secondary long-run void rates compared to current void rates.
- Prime and secondary long-run passing and estimated rental values (ERV) compared to current ones.
- Current and potential development supply compared to the long-run average.
- Capital flows into CRE – retail (e.g. open ended funds), institutional, domestic compared to international.

CRE DEBT MARKET DATA

- Total loans outstanding compared to the CRE universe.
- Loan vintages/expiries.
- CRE loan universe split by sub-sector (retail, office, industrial, etc.) and between prime and secondary.
- Loan concentration among lenders.
- Prevailing debt rates/margins compared to long-run averages.
- Prevailing swap rates compared to the long-run average.
- Cost of debt compared to initial and reversionary property yields.

OTHER TRACKING SUGGESTIONS

- Market share of different sources of equity capital entering the CRE sector (to the extent available), and proportion of CRE debt going to different types of borrower.
- The extent of financial innovation (periods of high innovation and increased complexity are often associated with booms).

Appendix 3: The Real Estate Finance Group

A3.1 Constitution of the Real Estate Finance Group

The Group has no formal constitution, being a group formed by individuals acting in their personal capacity with the objective of delivering, unconstrained, their best recommendations. The Group comprises a Review Group and six separate work streams (each with its own members) selected to ensure representation from a spectrum of, and for their knowledge of and expertise in, the real estate finance market, supported by a Support Group. The Group is grateful for funding that has been made available by the IPF to support its work, on terms that allow the Group to retain full discretion and editorial control over its recommendations.

REVIEW GROUP

Name	Organisation
Nick Scarles (Chairman)	Grosvenor Group Limited
Peter Cosmetatos (Secretariat)	CREFC Europe
Michael Brodtman	CBRE
Oliver Burrows*	Bank of England
Phil Clark	Kames Capital Plc
Dr Ian Cullen	IPD
John Gellatly	Aviva Investors
Ian Marcus	Ian Marcus Consultants Limited
Marc Mogull	Benson Elliot Capital Management
Max Sinclair	Wells Fargo Bank International
Shirley Smith	EY
Jonathan Thompson	Argent Group
Matthew Webster	HSBC Bank plc

* Attendance in order to provide technical support to the Group.

ADDITIONAL PEOPLE ON WORKSTREAMS

Name	Organisation
John Barakat	M&G
Dr Richard Barkham	Grosvenor Group Limited
Dr Neil Blake	CBRE
Sue Clayton	CBRE
Peter Denton	Starwood Capital Group
Sue Forster	Investment Property Forum
Dr Benedikt Kiesl	Hypothesenbank Frankfurt
Kevin Sale	Aviva (now retired)

SUPPORT GROUP

Name	Organisation
Douglas Marvin	KPMG LLP
Mark Peachey	The British Land Company Plc

INDUSTRY DISCUSSION CO-ORDINATION

Dr Paul McNamara	Investment Property Forum
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A3.2 Remit of the Group

The remit that the Group set itself at the outset is as follows:

“To consider and produce a vision for the real estate debt finance market in the UK, which meets the objective of ensuring an attractive, efficient and stable market, in the timeframe of the next cycle.”

Vision: Covers the nature and balance of participants in the market, the nature of their returns, the categories of the market in which they operate, the objectives of the regulatory framework affecting the market, and the broad nature, balance and types of debt finance available.

Real estate: UK commercial (i.e. not residential) real estate as might be determined investible by general real estate investors, therefore now including student accommodation, leisure and healthcare, but not other specialty asset types (such as infrastructure, offshore, mineral extraction, generation etc).

Debt finance: All debt finance, including hybrid, other than (in economic terms) pure equity, regardless of the nature or location of the lender.

Attractive: Ensures a balance of risk and reward, set at a level which encourages active participation throughout the market cycle.

Efficient: Market operates effectively and with transparency, with barriers to entry set at justifiable levels, and which encourages new participants into the sector.

Stable: The market mechanisms and regulatory processes provide a governor that increasingly discourages lending as, not after, values and aggregate lending rise above trend levels, encourages lending when markets fall below trend and is devoid of perverse incentives that fuel boom and bust. The market, and each relevant segment of it, is not over reliant upon a few lenders or lender types – diversification in almost every sense.

