CREFC Europe response to Central Bank of Ireland consultation paper CP 85: *Consultation on loan originating Qualifying Investor AIF*

CREFC Europe is grateful for the opportunity to comment on this consultation paper (the **CP**). While the subject matter of this consultation is of considerable interest to us, please note that our expertise is limited to commercial real estate (**CRE**) finance markets and our comments should be read accordingly.

CREFC Europe is a trade association promoting a healthy, sustainable and successful CRE debt market in Europe. Our core membership includes lenders and intermediaries who help connect capital seeking the risk and returns of CRE debt with real estate firms seeking finance. We seek constructive and effective dialogue with non-originating investors, borrowers and regulators in promoting CRE debt markets that support the real economy without compromising financial stability.

Introduction

We believe that greater diversification in CRE debt markets can support a more resilient financial system. Our chief executive is a member of the Real Estate Finance Group and principal author of its report, *A Vision for Real Estate Finance in the UK*, published in May 2014, one of whose recommendations relates to encouraging diversity.[1] We support regulatory initiatives to encourage broader and more diverse market participation, and would see CRE loan origination by investment funds (on an appropriately supervised basis) as a very positive development in that direction.

Having said that, our familiarity with the Irish market and regulatory environment is limited. Furthermore, due to the short comment period and its timing during the summer, we have found it difficult to get the level of input from members and other market participants that we would have liked. While we are not therefore in a position to provide informed responses to all the questions in the CP, we consider this a sufficiently important initiative to warrant submission of the comments we feel able to make.

Detailed comments

We welcome the Central Bank's proposal to allow loan origination by certain investment funds.

We agree that the proposal presents certain risks, as well as potential benefits, so the Central Bank is in our view right to explore appropriate and proportionate ways of mitigating those risks.

We would encourage the Central Bank to consider the final report of the UK Real Estate Finance Group, referenced in footnote 1. Alongside electronic submission of this response, we are sending you two bound copies of that report by post. While that report focuses on the UK and on commercial real estate finance (rather than lending markets more generally), we believe that there is much in it that may also be relevant more broadly – a view that has been reinforced in numerous conversations with European and international regulators in recent months.

Our more detailed specific comments are set out below.

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[1] The report can be found at https://www.ipf.org.uk/home/vision_for_real_estate_finance/default.aspx.
Recommendation 6 states: "*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.*".

1) Scope of the proposal

The final paragraph of the Introduction refers to rules that would apply to AIF "whose *sole strategy* is loan origination"; the first paragraph under the heading "Format of this Consultation Document" refers to AIF "with a *primary objective* of loan origination"; the proposed new "Loan originating Qualifying Investor AIF" definition refers to an AIF "*which issues loans*"; and proposed new Section 4.2 in Part II of the rulebook states that a loan originating Qualifying Investor AIF "shall *limit its operations solely to* the business of issuing loans, participations in lending and to operations directly arising therefrom, to the exclusion of all other commercial business" (emphasis added).

Two questions arise. The first is whether the rules relating to loan originating funds should prohibit or allow other activities to be carried on by originating funds (ensuring that the rules are clear). The previous paragraph suggests a lack of clarity at present. The second is whether issues might arise as to how the rules applicable to loan originating Qualifying Investor AIF should apply if and to the extent that loan origination is only an element of the AIF's activities.

On the first question, we would suggest that loan originating funds should, at a minimum, be explicitly allowed to (a) acquire existing loans, loan portfolios, and loan-backed securities from others, and (b) manage the loans (whether self-originated or acquired) and securities (whether subscribed for or purchased in the secondary market) they hold. These are activities that are so similar, and so commonly carried on under a single roof, that it is difficult to see a rationale for insisting that they be kept separate.

In addition, from the CRE perspective, at least, it would also seem sensible to allow such funds the flexibility of choosing from a broad range of different strategies for dealing with non-performing or otherwise problematic loans. For example, is there any reason why they should not be allowed to enforce or restructure their loans, either converting a loan into an equity interest in the borrower, or acquiring ownership of the real estate collateral? Given that such paths may be the best way of protecting value for investors, we believe they should be explicitly permitted.[2]

On the second question, if a loan originating fund could legitimately be, say, 50% invested in loans and 50% holding equity interests in real estate (as might happen, given the cyclical nature of credit and property markets), we would expect loan originating fund rules relating to the entity itself to apply to the fund, but loan originating fund rules relating to the activity of originating loans to apply only to that part of its business. Again, greater clarity in the rules would improve the proposed regime.

2) Credit assessment granting and monitoring

The proposals in this section sound reasonable, but we would warn against any overly prescriptive "one size fits all" approach to determining what constitutes an "effective" credit assessment and management process, as the answer may be different for different types of lending. The discussion below about risk diversification illustrates how CRE lending differs from ordinary business lending. The *Vision for Real Estate Finance in the UK* provides detailed discussion of CRE lending from the macro prudential perspective.

[2] We would distinguish cases where a funds strategy is "loan to own", purchasing existing loans or loan portfolios with a view to taking control of the underlying real estate. We can see why it may not seem appropriate for funds specifically authorised to originate new loans to be allowed to do so as part of such a strategy.

This is perhaps also a good place to make a broader comment. While we are very sympathetic to the Central Bank's desire to ensure that investors are adequately protected, we would argue that it is better to focus on ensuring they have transparency and clarity about investment strategy, risk profile and performance. Arguably, investment funds for Qualifying Investors only are a very good part of the financial system for higher risk/return investment opportunities to reside. Such funds should present little threat to financial stability (compared to commercial banks, for example). They can provide a visible, regulated mechanism for sophisticated investors to get yield in a low yield world, and for borrowers to raise finance for riskier projects. Risk is not a bad thing per se – indeed, it is an inevitable and healthy feature of any economy (and indeed of life); what matters is how well it is understood by investors, and whether it jeopardises financial stability.

3) Diversification

The proposed approach (based on limiting exposure "to any one issuer or group to 25% of net assets") does not seem appropriate in the CRE lending context, because it would not deliver meaningful risk diversification. It would be helpful to reserve some flexibility to explore alternative approaches that might be more effective in the CRE context.

Risk diversification in CRE is not generally best achieved at the borrower level. A CRE lender's credit exposure is principally to the borrower's tenants, rather than to the borrower itself. The lender is concerned, in the first instance, with the robustness and replaceability of rental flows under the leases that support the payment of interest (and any amortisation) during the life of the loan; and, in the second instance, with the value of the real estate, as repayment of capital outstanding on an enforcement or at loan maturity may depend on either a sale of the real estate or the raising of new debt against it. That is not to say that the borrower is irrelevant – but it is its asset management expertise, strategy and reputation that are key, rather than its creditworthiness.

4) Leverage

We agree that it is important to mitigate pro-cyclical vulnerabilities in funds which originate loans, particularly to the extent that they might infect the banking system or wider financial system. The *Vision for Real Estate Finance in the UK* extensively discusses how the challenges resulting from feedback loops between the property cycle and the credit cycle might be addressed.

While the proposed leverage limit of 1:1 for assets:borrowings does not seem unreasonable (provided sensible flexibility is allowed to deal with difficult market conditions), it may be worth considering alternative approaches in the CRE lending context. In particular, the volatility of asset values in CRE markets means that an approach that assessed leverage by reference to a more stable, long-term, through-the-cycle measure of value for the underlying assets of the fund (as recommended in *A Vision for Real Estate Finance in the UK*) might be both more meaningful, and more stable.

5) Disclosure and Reporting and stress testing

We agree with the Central Bank's interest in securing a good informational environment around loan originating funds. We also see merit, in this instance, of aligning requirements for banks and other originators of CRE loans. However, in the light of recent experience in CRE debt markets, we wonder whether the criteria applicable to banks (whether in relation to distressed loans or to loan level reporting) are the best way of providing the regulator with the quality of data that would support macro prudential supervision. Arguably, the crisis showed that neither all banks nor banking regulators had the right level of knowledge about bank loan portfolios.

In the CRE debt context, the commercial mortgage backed securities (**CMBS**) industry has developed a standardised template to facilitate the consistent transfer of data between CRE loan market participants. That template, the European Investor Reporting Package (**E-IRP**), is widely used to allow CMBS investors to track their investments. It has served as the starting point for CMBS data provision requirements imposed by the European Central Bank for its Data Warehouse and by the Bank of England for the use of its facilities. We are advocating its use as the starting point for a new UK CRE loans database to enhance market transparency for the benefit of market participants and regulators. The Central Bank may wish to consider the merits of such an approach in Irish CRE lending as well.

6) Interconnectedness with the banking sector

We agree that this is an area that regulators should monitor, and that it is reasonable, to that end, to require loan originating funds periodically to report undrawn committed credit lines and to monitor on-going connections between a credit institution and a loan originating fund. On the other hand, we do not entirely understand the Central Bank's thinking as regards risk retention requirements where a loan originating fund acquires loans from a credit institution. It is not clear what problem will be solved by imposing an obligation on the fund to obtain a warranty from the vendor that it will meet a specified risk retention requirement.

7) Prohibited loans

From the CRE perspective, we do not think it appropriate for proposed new Section 4.12 in Part II of the rulebook to prohibit loans to "other collective investment undertakings".

It is common for CRE assets to be owned by collective investment undertakings (we understand that Irish REITs are likely to be regarded as such, for example), and there may be cases where CRE is owned by joint ventures that are technically collective investment undertakings. We see no reason why loan originating funds should be prohibited from making loans to such owners of CRE assets (nor, indeed, why such owners of CRE assets should be denied access to this potential new source of finance). We would therefore recommend either removing or qualifying this restriction.

Please don't hesitate to contact me if you have any queries. We would be happy to assist you in any way we can.

Yours sincerely

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