CREFC Europe

Qualifying securitisation criteria and commercial real estate finance / CMBS

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

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

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

An evolving CRE lending and debt-investing universe. In recent times, CRE lending has been the preserve of the banks in Europe – leading to concentration risk and a lack of transparency or liquidity that continues to afflict Europe's financial system and economy. However, investors have long understood the attraction of CRE debt, which provides stable, long-term income with an illiquidity premium over larger segments of the fixed income universe, as well as security over income-producing physical assets. While the return of European banks to new origination is essential, it is surely in Europe's interests to promote a more diverse CRE debt market for the future.

A brief history of European CMBS. Before the crisis, Europe was beginning to follow in the steps of the United States, developing a CMBS market that could allow non-originating investors to gain exposure to CRE debt in a more liquid form, with far greater transparency and diversification potential than other products could offer. While some CMBS issues suffered rating downgrades, defaults and, in a few cases, losses during the crisis, CMBS was in fact almost irrelevant to the CRE-related vulnerabilities of Europe's financial system. On the contrary, it provided a mechanism for risk transfer and dispersal, some degree of liquidity in an inherently illiquid asset class, and transparency and data in a fundamentally private and opaque asset class. While pre-crisis CMBS had shortcomings, the crisis presented an opportunity for them to be identified and addressed, and the industry did just that, including through the development of CREFC Europe's Market Principles for Issuing European CMBS 2.0 (whose recommendations have generally been incorporated in post-crisis issuance).

CMBS as part of the solution. CMBS currently accounts for less than 5% of the European CRE debt market, and new issuance post crisis has been at very modest levels. Most non-bank investors have sought exposure to CRE debt by setting up their own origination platforms, making allocations to specialist fund managers, using joint ventures or participating in the syndication market. While that diversification is welcome, it is unfortunate that regulatory hostility to CMBS is driving capital to favour direct exposures over CMBS. CMBS has unique attractions over direct CRE lending, such as better risk diversification and secondary market liquidity, the existence of comparable performance data, and the discipline of the rating process. The way to protect banks, non-originating investors and financial stability is not to punish CMBS. Indeed, for EU insurers and other investors, there is a great deal to be said for investing in low risk CRE debt through senior CMBS exposures with those features, rather than through (often higher leverage) whole loans. Broader CRE debt market risks should be addressed by regulators and industry together taking forward the proposals for greater informational transparency, diversification and counter-cyclicality recommended in A Vision for Real Estate Finance in the UK.

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

(a) **Concentration limits** (*Article 243(2)(b) of the proposed CRR amendment regulation; new BCBS STC criterion D16*). The proposed condition that no single exposure/obligor should represent more than 1% of the underlying pool makes no sense at all in the CMBS context. CRE loans are usually non-recourse to the borrower – investors' credit risk is on the tenants liable to pay rent under leases, not on the borrowers. If diversification of credit risk is felt to be important (and that case has not been made in relation to CMBS), it needs to be at the tenant level. Indeed, a single underlying borrower can be beneficial, if it means that the cash flows from different leases and CRE assets are cross-collateralised (as they cannot be where they belong to different borrowers).

(b) **Credit quality** (*Article 243(2)(c)(ii) of the proposed CRR amendment regulation; new BCBS STC criterion D15*). It is proposed that no commercial mortgage loan in the pool must have a risk weight under the Standardised Approach of more than 50%. That is inappropriate, because it would serve simply to exclude CMBS: the normal risk weight for CRE loans (which are typically non-recourse and to unrated borrowers) is 100%. It would of course be possible to explore ways of controlling for credit quality in the CMBS context, and we would be happy to contribute to any such discussion – but there has been no such effort on the part of regulators.

(c) **Refinancing risk** (*Article 8(9) of the proposed securitisation regulation; BCBS STC criterion B7*). The Commission's proposal adopted a very sensible form of words on this point, requiring that repayment to investors should "not depend, substantially, on the sale of assets securing the underlying exposures". The BCBS criterion also adopts a relatively flexible approach. This is a genuine risk area for CMBS, and it is right that a test should apply to control for how it has been managed. However, regulators must resist a crude approach that rejects any refinancing risk, as that is simply incompatible with the underlying CRE debt market, and fails to recognise how refinancing risk can be managed and mitigated.[1]

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

[1] We are especially troubled by the EBA's earlier proposal that loans must be fully self-liquidating, and by the European Council's proposed inclusion of a recital (19a) explicitly stating that because of refinancing challenges facing some CMBS during the crisis, CMBS should simply be excluded from STS securitisation (a sorry return to the asset class-by-asset class approach of Solvency II). The Commission's approach is very much to be preferred.