Joint response to the Second BCBS Consultative Document *Standards: Revisions to the Standardised Approach for credit risk* (issued for comment by 11 March 2016)

We are grateful for the opportunity to comment on this consultative document (the **CD**). This is a submission agreed between, and made jointly by, three organisations: the Association of Property Lenders, the CRE Finance Council and CREFC Europe. A brief description of each organisation appears at the end of this letter.

The context

The CRE industry is a very important part of the real economy[1] and the way it is financed has a longstanding (and not always happy) relationship with financial stability. A sustainable flow of credit to that industry is vital if it is to serve the economy effectively and provide the returns that cause investors to fund the built environment of our towns and cities. Debt is often critical for making some of the most socially and economically important CRE investments viable, because equity funding alone is often too expensive or scarce for smaller-scale CRE investment outside gateway cities, for construction or development projects, and for the urban regeneration schemes that upgrade our social, urban and business infrastructure. It is often only the local branch networks of smaller regional or national banks that provide the debt required for such investment.

Those vital economic benefits must be weighed against financial stability risks, however. Poor lending decisions are a cyclical problem for banks, which will habitually lend over-exuberantly as the peak of the cycle approaches. Research[2] using securitised European CRE loan data highlights the overwhelming importance of cyclical factors in driving CRE loan performance. To date, neither lenders nor regulators have a strong track record of using counter-cyclical mechanisms to mitigate risk. The May 2014 report, *A Vision for Real Estate Finance in the UK*, published by an independent UK CRE industry group called the Real Estate Finance Group analyses the problems of feedback loops between the CRE cycle, the credit cycle and the regulatory cycle, and makes recommendations for how they might be addressed in a coherent, strategic and holistic way.[3] One of those recommendations is for the use of a long-term value metric to be used alongside market value to ensure that LTV ratios give a meaningful indication of risk having regard to the sustainable value of the collateral without allowing the volatility of market values to obscure it.

Banks (including many of the smaller, regional or national banks more likely to use the standardised approach) have a critical continuing role to play in financing Europe's CRE industry, even in a more structurally diversified CRE debt market. The importance of the Committee's proposals is all the greater in the light of proposals for capital floors based on the standardised approach.

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[1] See for example the 2015 industry report produced by the European Association for Investors in Non-Listed Real Estate Vehicles (**INREV**) and the European Public Real Estate Association (**EPRA**) available at https://www.inrev.org/news/31-publications/public-affairs/742-real-estate-in-the-real-economy.

[2] See for example this 2015 research paper from Bank of America Merrill Lynch (since updated in a January 2016 report): http://rcr.ml.com/Archive/11495307.pdf?q=ehy!VXncK6HJ0FhRBqy9jQ&__gda__=1457007170_9f43a5328c02c46d753bdee159f7c97b.

[3] The report is available at: http://www.ipf.org.uk/industry-involvement/a-vision-for-real-estate-finance-in-the-uk.html. While its focus is the UK CRE lending market (rather than a more global perspective), there is much in it that can help foster a sustainable (CRE debt) securitisation market.

This submission focuses solely on the proposals and questions specifically relating to real estate exposures, our area of expertise.

Submissions

We have the following comments on the proposals.

(1) The treatment of land acquisition, development and construction (ADC) loans should be made risk sensitive by including at least two different risk weights. This is a critically important form of finance from the point of view of the real economy, and the rules should recognise the value of effective risk mitigation. [*CD Annex 1, para 61*]

A single flat risk weight for all ADC finance, at a time when the Committee has recognised the importance of risk sensitivity in other areas, is in our view impossible to justify. ADC is economically critical, and while it is an inherently risky activity, there is ample scope for lenders to mitigate risk.

A range of subjective and objective factors contribute to the level of risk involved in ADC finance. Certain important factors (such as the track record, reliability, financial strength and overall quality of the sponsor) are difficult to measure accurately. Others are relatively easy to assess objectively: the loan-to-cost ratio, the extent of any pre-sales or pre-lets, and the extent of any completion guarantees or recourse to the sponsor.

<u>The Committee should introduce at least one additional risk weight, at a level at or below 100%, for ADC loans that score well on loan-to-cost, pre-sale/pre-letting and recourse metrics.</u>

(2) We welcome the proposal to introduce risk sensitivity for most real estate lending, but at least one additional risk weight should be added for very low risk lending against CRE where repayment is materially dependent on cash flows generated by the property. Failing to do so is likely to result in adverse selection problems. [*CD Annex 1, para 60, Table 12*]

Consistent with our comments in relation to the proposed treatment of ADC loans, we strongly support the introduction of a degree of risk sensitivity to way real estate exposures are treated under the Standardised Approach. Looking specifically at the proposed risk weights for CRE exposures where repayment is materially dependent on cash flows generated by the property (and leaving aside points covered above and below), we are concerned that a minimum risk weight of 80% is too high and will give rise to unintended and undesirable consequences.

In recent years, the UK's major domestic banks' IPRE exposures have been subject to slotting (with a minimum risk weight of 70% for IPRE exposures of more than 2.5 years' duration). Anecdotal evidence suggests that these banks:

- find it difficult to compete for the lowest risk CRE loans, and cannot reward reduced LTV, improved ICR/DSCR or other risk mitigation once a loan is already in the "strong" slot; and

- may prefer larger ticket loans that can be syndicated, and may find it harder to justify the cost and complexity of underwriting smaller ticket loans to SME borrowers (despite that being a core part of their business, and despite the reliance of many such borrowers on these banks for credit).

It is possible to carry out a CRE lending business on an extremely low-risk basis – chiefly by avoiding the exuberance of the peak of the property cycle, but more generally by appropriately monitoring key macro and property-related metrics (including LTV, ICR, DSCR and debt yields). Banks should be positively encouraged to do that, because CRE is critical urban and business infrastructure, providing a quasi-financial service that is especially important to new and growing businesses – and it needs to be financed.

The Committee should use the next QIS to determine thresholds indicative of very low risk for CRE lending that is materially dependent on the cash flows generated by the property, and use them to set an additional, lower risk weight for this category of exposure.

We would also question whether it is appropriate that the highest risk weight under the present proposal for IPRE is 130%, while the highest risk weight under slotting is 250%.

(3) We welcome the suggestion that prudent valuation criteria should be applied in relation to collateral property, including in particular a focus on sustainable value, but we would question whether that suggestion is as strong as it might be, and are disappointed that income measures of sustainability and risk are not given greater weight in the proposed framework. [*CD Annex 1, para 52, second bullet*]

In our response to the Committee's first consultative document on revisions to the Standardised Approach, we highlighted the dangers of reliance (by lenders and regulators) on market value-based LTV as a risk indicator. A 60% loan-to-(market)-value loan against a UK asset represented very different risks if it was made in 2003, 2006, 2009, 2012 or 2015, because the denominator, market value, is volatile. Recommendation 4 of *A Vision for Real Estate Finance in the UK* therefore recommended the development and use of a long-term value measure that might operate as an anti-cyclical mechanism both for risk assessment within firms and for the purposes of macro-prudential supervision.

We are pleased that the Committee has recognised the importance of that suggestion, but we believe that the proposal in the CD goes too far in one respect. We do not agree that a prudent and conservative valuation "should not be higher than the market value". Market values are only likely to be below long-term or sustainable measures of value after a property market crash. That is the point in the cycle when regulation should be gently encouraging cautious banks to provide credit to the real economy, both for economic reasons and because lending risk is objectively low.

The Committee should remove the prescription that "If a market value [for the property] can be determined, the valuation should not be higher than the market value".

More broadly, we are concerned that the proposal places so much weight on LTV as the risk differentiator, at the expense of income-based considerations, because it is no easy matter for national authorities to provide guidance setting out prudent valuation criteria to allow compliance with para 52 (in the absence of which the operational requirements in para 50 are not met and the risk-weights in tables 9, 10, 11 and 12 cannot be applied).

Real estate markets are generally opaque, and data challenges are especially acute in relation to CRE. Even in a market like the UK, which has one of the world's most transparent CRE markets, the very productive and collaborative work prompted by the *Vision* report recommendation to develop a long-term value concept is a slow and complicated process, giving rise to numerous questions that do not necessarily have simple answers.

The Committee should reconsider whether (and within what time-frame and with what degree of reliability and consistency) the use of para 52 compliant LTV is feasible, and whether any alternative approach to defining risk weights should be considered.

(4) We are concerned that the proposed requirement that "each bank" holding a lien on a property should have independent enforcement rights is incompatible with the way syndication markets work, with potentially damaging consequences for the availability of large ticket CRE loans. [*CD Annex 1, para 50, third bullet, (i)*]

The CD proposes that the operational requirements allowing the use of the risk-weights in tables 9, 10, 11 and 12 are only met if (among other things) "each bank holding a lien on a property can initiate the sale of the property independently from other entities holding a lien on the property".

At larger ticket sizes, the CRE finance market relies to a considerable extent on distribution or sharing of exposures, either through the securitisation market or through the syndication market. Current EU and BCBS initiatives to rehabilitate parts of the securitisation market regrettably continue to exclude CRE debt – an approach that has contributed to the continued marginalisation of CMBS in the European context since the financial crisis. European CRE debt markets have largely relied on a strong and diverse syndication market.

One characteristic of syndication is that it cannot allow each member of a syndicate to enforce independently of the others. It is difficult to see how European CRE syndication can continue to thrive if the requirement for unilateral enforcement rights is maintained. In the absence of compelling evidence that the syndication market presents risks that a measure such as this could address, it should be removed.

CRE finance serves the real economy and the risks it poses to financial stability can be managed and mitigated (as outlined, for example, in *A Vision for Real Estate in the UK*). Regulation cannot simultaneously impose penal costs on banks holding CRE debt on balance sheet, on the securitisation of CRE debt and on the operation of the CRE loan syndication market without undesirable consequences for the real economy (and, no doubt, risk build-up outside regulators' field of vision).

<u>The Committee should remove the requirement for any bank sharing security to have a unilateral right to enforce it.</u>

(5) More broadly, we are concerned that some of the language used in relation to real estate exposures is unclear or confusing and difficult to interpret in the context of real transactions. We provide some examples below.

- What exactly are the real estate exposures to which the "general treatment" is intended to apply (i.e. those where repayment is not materially dependent on cash flows generated by property")? Is the decisive feature the existence of recourse to a borrower or sponsor with other income, assets or activities? What distinguishes cases where there is "material" dependence from cases where the degree of dependence falls below the materiality threshold?

- In the context of ADC, when is "the source of repayment at origination of the exposure … either the future of uncertain sale of the property or cash flows whose source of repayment is substantially uncertain"? Is there a proportion of pre-sales or pre-lets that indicates sufficient "certainty"?

- Also in the context of ADC, what is a "finished property", and what distinguishes such a finished property from properties falling under the normal IPRE heading because they are income producing (and therefore by definition also finished)?

(6) Finally, and perhaps most fundamentally, we are not convinced that there is evidence to support some of the assertions on the basis of which distinctions are drawn that privilege certain types of real exposure over others.

The CD proposes different risk weights depending on (i) whether an exposure is secured on residential or commercial real estate, and (ii) whether or not repayment of the loan is materially dependent on the cash flows generated by the property. Aside from ADC (discussed separately above), the CD attaches the highest risk weights to CRE exposures where repayment is materially dependent on the cash flows generated by the property – which is the main form of finance available to the large majority of CRE businesses responsible for building, maintaining, renewing and managing our towns and cities. It is not clear why this most economically productive part of the real estate finance sector is singled out for special treatment (with only the arguably even more economically productive ADC segment getting worse treatment).

In the case of residential mortgages, it seems intuitive that the prospects for repayment of a loan and for recovery in the event of a default would be better where the lender has recourse to the borrower in addition to having security over the property. We are not familiar with the relevant data, but we suspect the data exists to substantiate the correlation asserted on page 11 of the CD.

However, the CRE lending market is very different. In the relatively mature and sophisticated jurisdictions with which we are familiar, it is a business-to-business sector in which lenders underwrite assets rather than borrowers and performance drivers are linked to cyclical factors and the quality of asset underwriting. We are highly doubtful that there is any evidence to suggest that an IPRE exposure with a 30% LTV presents a greater risk than a full-recourse residential loan with a 100% LTV – yet the CD proposes a risk weight of 80% for the former and 55% for the latter.

<u>If the Committee is determined to adopt a taxonomy that penalises CRE finance, it should at the very least introduce a lower risk weight for very low risk lending secured on CRE where repayment is materially dependent on cash flows generated by the property.</u>

Within the CRE context, we believe that the distinction drawn between cases where repayment is materially dependent on cash flows generated by the property and other cases is fundamentally problematic. Typically, individuals and small businesses seeking secured loans against relatively low value property are likely to be required to provide guarantees or other recourse. On the other hand, banks are likely to find it easier to rely on underwriting properties that are well located, benefit from reliable cash flows and are owned and managed by substantial sponsors of good standing with a strong track record. In other words, the fact that repayment is materially dependent on the cash flows generated by a property may indicate that the lender is comfortable underwriting the property risk. That judgment may not be reliably correct (as the reports mentioned in footnotes 2 and 3 show) – but the solution is not simply to impose higher risk weights for specialist CRE lending.

<u>The Committee should reconsider whether it is appropriate and justified by the evidence to draw a distinction that penalises CRE loans where repayment is materially dependent on cash flows generated by the property as compared to other CRE loans.</u>

We hope our comments are helpful and would be delighted to discuss them with you in further detail at your convenience. Please contact Peter Cosmetatos in the first instance.

Yours faithfully

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The signatory organisations

The APL was established in 1991 to provide a forum for property bankers active in the United Kingdom to meet and discuss topical issues and to share experiences and advice.

Since then the association has grown to nearly 500 individual members, being actively involved in commercial real estate finance, representing about 90 different lending organisations. The association has three core principles (i) to educate and inform new and existing members on any issues related to property finance by organising a variety of seminars and presentations, (ii) to provide networking opportunities for members to discuss topical issues and (iii) to interact with the wider property industry on financial and related matters.

The CRE Finance Council is the collective voice of the entire $3.5 trillion commercial real estate finance market. Its members include all of the significant portfolio, multifamily, and commercial mortgage-backed securities (**CMBS**) lenders; issuers of CMBS including banks, insurance companies, Government Sponsored Enterprises (**GSEs**), and private equity funds; loan and bond investors such as insurance companies, pension funds, specialty finance companies, Real Estate Investment Trusts (**REITs**), and money managers; servicers; rating agencies; accounting firms; law firms; and other service providers. Our industry plays a critical role in the financing of office buildings, industrial complexes, multifamily housing, shopping centers, hotels, and other types of commercial real estate that help form the backbone of the American economy. Our principal functions include setting market standards, facilitating the free and open flow of market information, and education at all levels. Securitization is one of the essential processes for the delivery of capital necessary for the health of commercial real estate markets and broader macro-economic growth. One of our core missions is to foster the efficient, transparent and sustainable operation of CMBS. To this end, we have worked closely with policymakers to educate and inform legislative and regulatory actions to help optimize market standards and regulations.

CREFC Europe is a trade association promoting a diversified, sustainable and successful commercial real estate (**CRE**) debt market in Europe. Our core membership includes commercial and investment banks, as well as other 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 not only with banks, but also with non-originating investors, borrowers and regulators in promoting CRE debt markets that support the real economy without compromising financial stability.