CREFC Europe

HM Treasury Review of Solvency II: Consultation

Response of CREFC Europe

The Commercial Real Estate Finance Council (**CREFC**) Europe is the industry association representing real estate debt providers and the wider real estate finance market in the UK and Europe. We promote well-functioning, responsible and sustainable markets that are appropriately transparent and liquid. These markets should serve both institutions investing capital (their own or on behalf of others) and real estate businesses (large or small) seeking credit, without presenting unacceptable risks to financial stability.

We lack the specialist expertise to respond to the specific questions posed in the consultation paper. However, we have a good understanding of real estate credit markets, including the different channels that life companies use to gain exposure to real estate credit. Our main aim in responding this consultation is to explain why and how we think that the Solvency II Review is an important opportunity for the UK to correct EU legacy regulatory barriers to investment in securitised real estate credit (alongside unsecuritised real estate credit) by life companies.

It is worth clarifying that only a minority in our membership is directly concerned with the size and health of real estate debt securitisation. That is principally because of the decline of real estate debt securitisation (including commercial mortgage-backed securities (**CMBS**)) across Europe since the global financial crisis (**GFC**). That, in turn, was largely a result of the European regulatory response to the GFC (including the definition of the STS/non-STS boundary and the capital charges applicable to securitised real estate debt (as non-STS securitisation exposures) under Solvency II. The regulatory arbitrage created by EU policymakers distorted the substantial investment by life companies in real estate credit since the GFC, driving it to unsecuritised channels and products (only life companies using internal models continued to invest in CMBS).

Key messages

Real estate credit helps fund (with lower risk/cost capital than investors' equity) the productivity-enhancing real estate industry, which provides quasi-financial services to SMEs and other businesses by providing and managing premises for rent, thereby allowing businesses to use capital and other resources for their core business and not to build or buy premises from which to operate. It also finances the repurposing and decarbonisation of existing buildings, which need investment both generally to remain fit for purpose and to meet the climate challenge.

Real estate finance markets that are diversely sourced and reliant on a variety of different channels and products are inherently more resilient both for credit supply to the real estate market and for financial stability. We therefore welcome the emergence of non-bank lenders (often managed by and/or deploying capital from life companies) in the real estate finance market post-GFC.

There are specific additional benefits from a functioning securitisation market in real estate finance, but it has been stymied by the post-GFC regulatory framework put in place by the EU.[1] As an investable asset class, securitised real estate credit offers a different combination of attributes compared both to more

[1] In common with most forms of securitisation, issuance of CMBS in Europe has failed to recover to anything remotely resembling pre-GFC levels, or in the way that corresponding issuance has recovered in the United States, where the regulatory response to weaknesses revealed by the GFC was much more balanced than in Europe. While excessive exposure to real estate can be problematic for banks and financial stability, non-bank investors have long found the risk/returns of real estate credit attractive, especially if, like life companies, they value an illiquidity premium more than high liquidity. The penal treatment of CMBS under Solvency II has led most insurers to seek real estate credit exposure through direct loans or allocations to debt funds. Direct lending maximises visibility and control, but with minimal secondary market liquidity, comparability or transparency. Allocations to debt funds effectively outsource the infrastructure required for a direct lending business, but still lack the enhanced secondary market liquidity, comparability and transparency offered by CMBS. There should be room for all these products – securitised as well as unsecuritised – in the market.

liquid fixed income products, and to unsecuritised forms of real estate credit exposure. In particular, it offers transparency and comparability (to an otherwise opaque asset class) as well as some secondary market liquidity (for an otherwise illiquid asset class). These are significant benefits given the cyclical risks inherent in real estate and the way real estate debt markets can affect financial stability (exemplified in the GFC, and discussed in the 2014 report *A Vision for Real Estate Finance in the UK*).

In the highly developed US market, CMBS delivers (among other things) a standardised, ten-year duration, prepayment protected, fixed rate loan product that works well for life companies, while that model offers finance on different terms than the commercial banking market for real estate borrowers.

The Solvency II SCR capital charges applicable to securitised real estate debt under the standard formula for spread risk are unjustifiably penal, as shown by the BofA Securities research report extracts available here. If the UK can fix that EU regulatory error, the benefits would be felt by:

- insurance firms seeking exposure to real estate credit (by removing an unjustifiable regulatory barrier to the most transparent, comparable and liquid real estate credit exposures available); those firms using internal models and thus already able to invest in securitised real estate credit would also benefit as the ability of standard formula-users to access the asset class would help the sector scale, improving choice and liquidity),

- financial stability (by adding diversity and market transparency to real estate finance markets more broadly, through the anticipated recovery of securitised real estate debt alongside other, more opaque and less liquid alternatives)[2], and

- the real estate economy, as more productive capital becomes available to help pay for the enormous capital requirements of decarbonisation, as well as of keeping buildings fit for purpose in a changing, post-pandemic world (for the same reasons – especially if the market for CRE CLOs[3] can open up, benefiting non-bank lenders with an appetite for value-add, transitional lending opportunities).

We would be very happy to discuss our submissions and their implications further with officials. Please contact Peter Cosmetatos on pcosmetatos@crefceurope.org or 07931 588451 in the first instance.

[2] It is worth remembering that it was (relatively unregulated, pre-GFC) CMBS markets that offered valuable insights into the state of real estate debt markets during the GFC, for regulators as well as for industry participants, before there was any clarity as to what was happening in the real estate loan books of (highly regulated) banks.

[3] For information about CRE CLOs, see for example this primer on CRE CLOs from Scope Ratings.

More detailed submissions

There are enormous, socioeconomically important challenges ahead for the real estate sector, in terms of decarbonisation, as well as to ensure that the built environment remains fit for purpose in the face of changing technology and social norms for how we live, work and spend our leisure time. The long-term capital that life companies can deploy could play a vital, productive role in delivering the requisite investment. Some of this naturally flows into real estate in the form of direct investment in the ownership of buildings. But much of the real estate market is not of institutional quality, yet needs to finance retrofit and other upgrades – and life company capital could be a good fit for providing credit to support that.

There is no evidential basis whatsoever to justify regulatory barriers that steer insurers' real estate credit investments solely into unsecuritised, rather than also into securitised, products (for firms using the standard formula). There are two main problems with the regulatory framework as it currently applies in this context.

1) The first problem is the automatic classification of securitised real estate debt as non-STS under European rules. Under the EU's Solvency II framework, CMBS and other securitised real estate debt are effectively excluded entirely from the possibility of improved capital treatment under the "simple, transparent and standardised" (STS) framework.[4] Besides missing an opportunity to incentivised well-structured real estate debt securitisation through the carrot of STS treatment, the result is capital charges under the standard formula that effectively make securitised real estate debt uninvestable. Insurers using the standard formula are almost certain therefore to prefer alternative ways of gaining exposure to the risk/return of real estate credit.

2) The second problem is the spread risk capital charges imposed under the standard formula on securitised real estate debt (as non-STS). This problem has a number of different elements.

    (i) The spread volatility in CMBS during the GFC reference period does not justify the current, highly distortive regulatory framework. Research from BofA Securities (collated here) shows that over 25 years, UK and European CMBS volatility has been similar to that of REITs and broader corporates, and returns were less volatile than those of REIT bonds. Yet the capital charges are multiples of those applicable to those types of exposure and even compared to the capital charge for direct ownership of real estate.

    (ii) CMBS volatility during the GFC reference period was exaggerated by leveraged holding structures that are no longer in use.[5]

    (iii) The relatively high spread volatility of CMBS reflects the fact that this is a small but public market. Spread volatility in the opaque and private real estate loan market is almost certainly not lower – but it is hidden, because there is effectively no secondary market for

[4] Recital (29) Securitisation Regulation prejudges against the natural interpretation of Article 20(13), which would incentivise good practice by differentiating between CMBS by reference to the nature and degree of dependence on the sale of assets. CMBS is also effectively excluded from STS capital treatment because of the requirement that no single exposure/obligor should represent more than 2% of the underlying pool – a rule that makes no sense for non-recourse real estate loans, where credit risk diversification should be tested, it at all, at the tenant level. The resulting capital charge for five-year duration AAA CMBS is, at 67%, more than two and a half times the 25% for direct real estate, and even more compared to the much smaller capital charges for unsecuritised real estate debt investments.

[5] Pre-GFC, European CMBS exposures were largely held by SIVs, leveraged vehicles subject to margin calls, rather than by 'real money investors' like life companies. Market stress and value falls triggered margin calls which forced distressed sales and further value falls. Opportunistic investors who acquired CMBS at large discounts mostly saw substantial profits when prices recovered just a few months later. Those leveraged holding vehicles are no longer a feature of the European CMBS market, which is dominated by buy-to-hold investors. Accordingly, the price volatility that one would expect to see in a period of comparable market stress should be lower.

such loans. Yet the capital charges under Solvency II assimilate real estate loans to the liquid corporate bond market for the purposes of capital charges. The result is a huge regulatory arbitrage in favour of unsecuritised real estate debt over securitised real estate debt.

(iv) Secondary trading is not common in the real estate credit investment market (whether securitised or unsecuritised). Life companies are especially likely to hold to maturity, matching income to long-term liabilities and enjoying the yield premium over more liquid assets. That is certainly our clear impression based on anecdotal reports from the CMBS investor market (although we also gather that the improved secondary market liquidity that would likely accompany a larger securitised real estate credit market would be welcome).

(v) The fact that life companies are unlikely to need to liquidate CMBS (or indeed unsecuritised real estate credit investments) in a crisis suggests that credit risk might be a more suitable framework for setting capital charges than spread risk.[6] There is no evidence that the securitisation of real estate debt increases credit risk (any more than spread risk) for noteholders, or indeed even at the loan level. On the contrary, securitised real estate loans appear to perform better than loans retained on bank balance sheets. The BofA Securities research points out that the 4% of principal losses arising on real estate loans originated and sold via conduit securitisation by UK banks between 2000 and 2008 compares favourably to the 9% write-offs cited by the Bank of England for non-securitised real estate loans. From a credit perspective, a level playing field for life companies would surely be more sensible than the current regulatory bias against securitised exposures.

The current regulatory framework inherited from the EU's Solvency II framework could be improved in a number of ways as it applies to (and affects) real estate credit, including, but not solely, in ways outlined in HM Treasury's consultation paper:

- The STS criteria should be re-formulated and/or interpreted in such a way as to encourage well-structured real estate debt securitisations, by rewarding well-structured transactions with STS capital treatment. Simply excluding an entire product category and asset class is poor regulation and creates regulatory arbitrage risk that distorts the market.

- While we understand that it is less common in the UK than in the EU for life companies to be using the standard formula, the capital charges applicable to securitised real estate debt under the standard formula should be reduced. The analysis contained in the BofA Securities research shows that neither spread volatility nor credit risk can justify penal regulatory treatment for securitised exposures. A level regulatory playing field would allow life companies to choose the type and combination of real estate credit exposures that best suits their requirements.

- A focus on credit risk would seem to be more rational than the combination of spread risk and duration risk that the standard formula is based on (though it may be that widespread use of the matching adjustment may be an alternative solution).

- We would expect the changes proposed to the operation of the matching adjustment (eligibility, treatment of construction projects, treatment of sub-investment grade assets) to help to lower

[6] The BofA Securities research assesses the credit performance of European CMBS over its 27-year history. Almost all CMBS losses arose in transactions issued in 2005-07, at the peak of CMBS's first property cycle, which ended with the GFC. For notes originally rated AAA, principal losses have amounted to just 0.3% of aggregate issuance. Total principal losses are just 2.2% of European CMBS since 1995. The industry has worked hard to improve CMBS since then (even in the absence of regulatory encouragement via the carrot of STS capital treatment) – notably through *Market Principles for Issuing European CMBS 2.0* (available here). With better practice in post-GFC issuance, credit performance has been good, with no principal losses for noteholders to date.

unnecessary and unjustifiable regulatory barriers to investment by life companies in securitised real estate credit.

- Having watched with dismay as EU regulators implemented poorly thought-through and inadequately consulted-upon disclosure frameworks for asset classes that they evidently do not really understand, we would in general support moves to keep UK reporting frameworks as proportionate, streamlined and targeted as possible.

Considerations for net zero

The most established securitised real estate credit product is CMBS – and the truth is that CMBS is not well-suited to brown-to-green strategies. But in the real estate debt market, securitisation is more than CMBS. It can act as a tool for banks to recycle their capital (notably via conduit CMBS), or as a means for real estate firms to access credit from the capital markets directly (so called agency CMBS). But beyond conduit and agency CMBS, there is also untapped potential for non-bank real estate lenders to access the capital markets via CRE CLOs (well developed in the US market, but nascent on this side of the Atlantic).[7]

CRE CLOs could prove especially suitable for the kind of value add, transitional lending that can finance brown-to-green strategies to upgrade and retrofit existing buildings. Such strategies are often more appealing to non-bank lenders, and the loans involved are less suitable for CMBS as they are often short duration and may not produce income until repayment. CRE CLOs face enough entirely legitimate challenges to gain the confidence of investors and become established in the market without the regulatory playing field being tilted heavily against them.

Unjustifiably penal standard formula capital charges for securitised real estate debt arbitrarily restrict the appetite of life companies for all of these products. As a result, the potential of securitisation to support a diverse real estate financing market with a degree of transparency, standardisation and secondary market liquidity missing from other real estate credit products is needlessly compromised. The additional potential of the securitisation market to channel investment into financing the decarbonisation of buildings will surely be missed if the problems discussed in this response are not addressed.

[7] See footnote 3.