CREFC Europe

Response to the BCBS-IOSCO Consultative Document *Criteria for identifying simple, transparent and comparable securitisations* (issued on 11 December 2014 for comment by 13 February 2015)

CREFC Europe is grateful for the opportunity to comment on this consultative document (the **CD**).

CREFC Europe is a trade association promoting a diversified, sustainable and successful commercial real estate (**CRE**) debt market in Europe. We believe that securitisation has an important part to play as a component of that market. 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.

Executive summary

1. We agree:

(a) with the objective of promoting sustainable securitisation markets – both to rekindle credit flows and to diversify risks – and with many of the specific criteria proposed;

(b) that the financial industry should be encouraged to develop simple and transparent securitisation structures;

(c) that the negative attitude towards securitisation of non-bank investors such as insurance companies, pension funds and investment funds, needs to be addressed; and

(d) that there is a danger that some investors may regard criteria developed by regulators to identify simple, transparent and comparable securitisations as a substitute for due diligence (as external credit ratings have been regarded in the past).

2. It would be very useful if your work in this area could include more explicit reference to CRE debt securitisation and commercial mortgage backed securities (**CMBS**) to ensure that there is an adequate focus on the way the proposed approach might accommodate them.

3. We respond to the questions in the CD and comment on the proposed criteria below. First, we would like to emphasise the following key points.

(a) When pursuing their broad policy objectives for the securitisation market, regulators should resist the temptation to adopt a 'one size fits all' approach. The objectives are as important within the context of a specific securitisation asset class (such as CMBS) as they are across securitisation generally. A single set of rigid criteria is not likely to apply in an appropriately neutral and discriminating way across different securitisation asset classes – as a number of recent European initiatives demonstrate. We are pleased to see a more flexible approach adopted in the CD.

(b) A connected point – to quote a recent IMF staff discussion note (**the IMF paper**)[1] – is that: "Proposals for a binary (high-low quality) aggregate classification system risk creating a fragmented market with significant pricing discontinuities". Furthermore, the creation of aggregate risk labels by the official sector may encourage "shirking" by investors and create moral

[1] SDN/15/01 of January 2015, written by Miguel Segoviano, Bradley Jones, Peter Lindner and Johannes Blankenheim, available at http://www.imf.org/external/pubs/ft/sdn/2015/sdn1501.pdf.

hazard risks (as also noted in the IMF paper). That warning should be born in mind when designing criteria as well as at the stage when differentiated regulatory provision is made.

(c) If the aim of attracting non-bank investors to securitisation markets is to be realised, it is vital that securitisation is (to quote the IMF paper again): "treated comparably to securities with broadly similar risk characteristics to avoid unintended adverse consequences, including the concentration of risk in new areas and regulatory arbitrage". The context (which, in the CRE debt context, includes covered bonds and loans that investors might choose to originate or invest in directly) is crucial. The private and opaque nature of the unsecuritised CRE debt market presents real challenges here, as it renders difficult any meaningful comparison with the very public characteristics and performance of securitised CRE debt.

(d) Finally, the same IMF paper correctly notes the importance of loan origination practices and underwriting standards in damaging the credibility of the securitisation market and contributing to the financial crisis. That is especially true in the case of CRE debt (whether or not securitised). A 2014 industry report, *A Vision for Real Estate Finance in the UK*[2], analysed the feedback loops between the property cycle, the credit cycle and the regulatory cycle with a view to increasing the resilience of the banking and wider financial system to the property cycle. We are actively supporting the implementation of its recommendations, which include the following:

(i) The creation of a comprehensive CRE loan database to improve transparency in a systemically important but chronically opaque market (the IMF paper makes a policy recommendation along these lines on p24, and the Bank of England has signalled its intention to explore how it might best be implemented[3]);

(ii) Better expertise and insight for the regulator, including through reliable access to industry input (the IMF paper makes a policy recommendation along these lines on p17);

(iii) The use of long-term value measures for risk management, in particular when banks calculate loan-to-value ratios, to counter the pro-cyclical effects of focusing on market value in a rising market;

(iv) Improved alignment between regulatory capital requirements and economic risk;

(v) Promoting diversity in the supply of debt to the real estate market (including through a healthy and sustainable securitisation market with a diversified non-bank institutional investor base with a long term horizon, such as is recommended in Part C of the IMF paper);

(vi) A regulatory system designed to work smoothly and predictably across, and counter to, the cycle, rather than relying on judgment-based interventions to restrain overheating markets or stimulate activity after a crash (judgment-based regulation of cyclical markets does not have a good track record).

4. The CRE industry is a very important part of the real economy; in the EU, the sector's 2013 contribution to gross value added was more than EUR300 billion, with the market value of assets exceeding EUR5 trillion and almost 4 million people directly employed.[4] Debt is an essential component

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[2] The report, produced by the Real Estate Finance Group, 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, or securitisation), there is much in it that can help foster a sustainable (CRE debt) securitisation market.

[3] See http://www.bankofengland.co.uk/financialstability/Documents/securitisation/responses281114.pdf.

[4] See the 2014 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 here https://www.inrev.org/news/31-publications/public-affairs/742-real-estate-in-the-real-economy.

of the funding mix for the CRE industry[5] – but the way CRE is financed has a longstanding (and not always happy) relationship with financial stability. A sustainable CRE debt securitisation market could improve transparency and diversity and promote stable and sustainable credit flows to businesses in the real estate sector, particularly if it could grow as a proportion of the total stock of CRE debt (see footnote 5). That should result in greater choice for both borrowers and non-originating debt investors, creating healthy competition, supporting rather than undermining financial stability. For that to happen, regulatory efforts to revive sustainable securitisation markets need to have regard (among other things) to the specific characteristics of CRE debt markets.

5. That general point is also specifically relevant when it comes to promoting comparability. CMBS is just one of a number of ways in which investors can gain exposure to CRE debt.[6] Aside from the substantial benefits of greater transparency in the underlying CRE lending market, "comparability" is often an unrealistic and unhelpful goal owing to the fundamentally heterogeneous and non-granular nature of CRE (which in turn affects how it is financed).

Detailed responses and comments

Questions 1 and 2 are complex and comprise numerous more specific questions all relating to the criteria set out in the annex to the CD. Rather than seek to provide standalone answers to Questions 1 and 2, we comment on each of the criteria from the point of view of the CRE finance industry, below.

Question 3 seeks views (and data) in relation to short-term securitisation markets. As a relatively long-term asset class, CRE debt is not a natural fit for short-term securitisation markets. Accordingly, we have no comments on this question.

Question 4 asks respondents for their views on the level of standardisation of securitisation transactions' documentation. As a general matter, we strongly support greater standardisation because it can provide the kind of consistency and comparability that makes due diligence easier for investors. However, care is needed because while some securitisation asset classes are highly granular and homogeneous, lending themselves to standardised documentation, others are not.

CMBS can accommodate modest levels of standardisation (relative to some other securitisation asset classes), because the underlying loans and CRE collateral are 'lumpy' and highly heterogeneous; much of the documentation needs to be written or negotiated transaction by transaction. CREFC Europe and other industry groups and initiatives have nevertheless sought to introduce greater standardisation in loan documentation and securitisation documentation, as well as promoting industry standards and best practice in investor reporting and other areas. Examples are our *Market Principles for European CMBS 2.0*, our work promoting a standardised approach to CMBS investor reporting, and the recent and ongoing development by the Loan Market Association of a new suite of standard form documents specifically designed for real estate finance transactions.[7] There is undoubtedly room to build on those efforts, but we believe those within the industry who truly understand the asset class are the best people to do that.

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[5] A recent analysis from CBRE (available at http://portal.cbre.eu/portal/pls/portal/docs/1/56053844.PDF) estimated the total stock of CRE debt in Europe at close to EUR1 trillion. CMBS accounts for a very modest part of that overall amount – somewhere between EUR40 billion and EUR70 billion, depending on whether one includes certain longer dated fixed-rate bonds that are typically traded by corporate bond rather than ABS desks (sources: Trepp and Bank of America Merrill Lynch).

[6] Other ways of investing in CRE debt include lending directly, participating in the CRE loan syndication market, investing in the private placement market in CRE debt, and investing through an investment management firm that itself makes CRE loans or invests in CRE debt. Market-based CRE finance generally has become increasingly important in recent years.

[7] See, respectively, http://www.crefc.org/eucmbs20/; http://www.crefc.org/e-irp/; and http://www.lma.eu.com/documents.aspx?c=100.

A. Asset risk

1. Nature of the assets

We agree with certain aspects of what is proposed for these criteria, and disagree with others.

Homogeneity as regards general asset type seems reasonable, but we are not convinced that a bar on multiple jurisdictions, legal system or currencies can be justified – particularly in the context of the United Kingdom (which has more than one legal system) or the European Union (which seeks to promote a single market across numerous jurisdictions, legal systems and currencies).

We agree that transaction documentation needs to be clear about (among other things) rental, principal, interest and payments – but the reference in the CD to "defined terms" is confusing. Transaction documentation would invariably define terms in these areas, without that necessarily implying clarity.

As regards interest rates, it is unclear how one determines where the boundary is between formulae that are "complex or complicated" and those that are not, and between derivatives that are "exotic" and those that are not. We would prefer a criterion that is explicitly flexible enough to accommodate the judgment that would surely need to be exercised (with potentially different results in different deals and market segments, and at different times).

Additional consideration: As noted above, we would prefer any further definition of the terms "complex or complicated formulae", "exotic derivatives" and "homogeneity with respect to geographical origin" to make it clear that those terms are recognised as being subjective and do not have a fixed meaning.

2. Asset performance history

We do not think the criteria proposed here are appropriate. Generally, it is not clear what comprises "new and potentially more exotic asset classes", other than perhaps in relation to granular and homogeneous asset classes with no existing statistical track record. The approach to due diligence and the importance of asset performance history are very different in the case of an asset class like CRE debt, which is private, heterogeneous, cyclical and non-recourse. In particular, we see no reason why securitised debt secured on emerging CRE asset classes (for example, student accommodation or healthcare or leisure facilities) should be viewed with suspicion. On the contrary, we feel the growing overlap in many investors' eyes between "commercial real estate" and "infrastructure" is welcome and should be encouraged, including through the way related financial products are regulated.

For securitised CRE debt, credit underwriting by prospective investors should focus on the loans and collateral before them; a statistical analysis based on historical data is not usually appropriate, and can be positively unhelpful as a guide to assessing a specific proposed investment. To the extent that there is significant demand among investors for historical data (for example, a few years' rental and cost or construction data for the actual collateral involved), that is made available.

Additional consideration: The discussion here is sensible, provided that any requirement for historic performance is sensitive to the particular asset class and circumstances. For example, given the importance of the specific collateral and loan(s) in the context of a proposed CRE debt securitisation, there may be little meaningful value in a requirement for the originator to demonstrate a track record.

3. Payment status

We agree with the proposed criteria.

Additional consideration: We agree with the point made, subject to noting the importance of ensuring that terms are defined in a way that is sensitive to the characteristics of different securitisation asset classes.

4. Consistency of underwriting

We do not think this proposed criterion is appropriate, at least in the CMBS context. It implies that only securitisations originated by established lenders can be "simple" and that investors invest based on statistical analysis. Those assumptions are incorrect in the CRE debt context, where the effect would be to rule out CRE debt securitisations without originators (such as agency CMBS)[8], as well as CRE debt securitisations by new entrants to the lending market.

More generally, for a concentrated and heterogeneous asset class like CMBS, it is usual for a deal to involve only a small number of assets. As a result, asset level analysis is possible, realistic and desirable for most institutional investors, as well as being more appropriate than statistical analysis. The inappropriateness of statistical analysis also means that both granularity and the existence or performance of other exposures originated by the same originator will generally be irrelevant.

5. Asset selection and transfer

We have no objection to the proposed bar on reliance on selection of assets through "active management on a discretionary basis" because that is not a feature of CRE debt securitisations. However, random selection of credit claims or receivables would in the large majority of cases be entirely inappropriate in relation to the securitisation of CRE debt. That is because of the nature of CRE (and thus also of CRE debt) as a lumpy and heterogeneous asset class which is usually most appropriately and effectively analysed through asset-specific due diligence and not by statistical methods. This is not a market in which it is easy to lay down standard eligibility criteria.

As regards other aspects of the criteria proposed here, in particular those relating to true sale, we would again draw attention to agency CMBS (mentioned in our comments on the proposed criteria for consistency of underwriting and outlined in footnote 8). If such transactions fall to be regarded as "securitisations" for regulatory purposes, it would not be appropriate for the fact that they do not involve a true sale to exclude them from any privileged simple, transparent and comparable classification.

Additional consideration: As we understand it, the issues discussed here are not generally relevant for our members so we have no comments on the additional consideration.

6. Initial and ongoing data

CMBS investors are typically provided with a very detailed level of due diligence information, including tenant, lease and property level information as well as information about borrowers and loans – either for every loan (where the number of loans is small) or for the largest loans (where there are a larger number of loans in the pool). It is rare for securitised CRE debt to involve granular pools, so we agree that criteria should be formulated in a way that can accommodate different approaches depending on whether the pool is granular. Eligibility requirements will not general be relevant in the context of non-granular securitised CRE debt.

[8] Agency CMBS consist of bond financing being provided directly to a real estate-rich business, rather than involving the refinancing in the capital markets of a loan or loans advanced by a bank. The corporate borrower group is the originator of the capital markets transaction and is exposed to market risk until it is executed. Agency securitisations are, in effect, secured corporate bond issues which rely on cash flows from the assets of the business in question. They are not a bank financing tool.

B. Structural risk

7. Redemption cash flows

This proposed criterion needs to be reconsidered in the context of CMBS. It is neither feasible nor necessary to eliminate refinancing risk altogether in order for investors to be able to analyse potential securitised CRE debt investments.

Refinancing risk is a risk for all (rather than only securitised) European CRE debt, because the CRE debt market is, in general, a bullet repayment market with no (or relatively modest) amortisation during the term of loans which, when originated by the traditionally dominant banking sector, would not normally have a term of more than five to seven years.

Refinancing risk is specifically a cyclical risk because of the strong feedback loops between the property cycle and the credit cycle, and the historic tendency of regulatory regimes to act on the CRE debt market in a pro- rather than counter-cyclical way. The last boom demonstrated how lending volumes increased, margins and covenant protection fell, and regulators and policymakers failed to sound the alarm or to ensure that banks built up adequate capital as the peak of the market approached. When the crisis struck, CRE debt exposure in Europe was overwhelmingly concentrated on the balance sheets of certain banks, with only a modest amount having been securitised.

The fact that it is far easier to observe the performance of securitised CRE debt than that of CRE debt retained on bank balance sheets does not mean that problems relating to redemption cash flows are a function of securitisation. They are not. Imposing a "high quality" securitisation criterion that is incompatible with the underlying CRE debt market will not help to reduce refinancing risk in that underlying market. It is more likely to lead to poorer visibility about the scale and nature of that risk, and about where it lies. This is not an issue that should be tackled from the narrow perspective of developing sustainable securitisation markets.

We believe refinancing risk is something that needs to be addressed at the level of the underlying CRE lending market, through a combination of better information and transparency, better understanding of cyclical risk among market participants and regulators, and structurally counter-cyclical regulation. *A Vision for Real Estate Finance in the UK*[9] contains a thorough analysis and makes specific recommendations for doing that.

As far as the narrow objective of this consultation is concerned, we would recommend a more flexible approach that focuses on information rather than hard and inflexible requirements. Specifically, issuers could be required to provide prospective investors with a comprehensive and contextualised explanation of how refinancing risk has been managed and mitigated, through both the structure of the underlying loans (LTVs, amortisation, etc.) and the structuring of the securitisation itself (tail period between loan maturity and legal final maturity of the bonds, etc.). More modestly, the simplest point would be to recognise – in line, indeed, with post-crisis market practice – that longer tail periods between loan maturity and legal final maturity of the bonds mean that the underlying assets "do not need to be refinanced *over a short period of time*" [emphasis added].

8. Currency and interest rate asset and liability mismatches

We agree that interest rate and currency risks should be appropriately mitigated (and both the risk and the mitigation appropriately disclosed).

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[9] The UK report referenced in footnote 2 and available at: http://www.ipf.org.uk/industry-involvement/a-vision-for-real-estate-finance-in-the-uk.html. As mentioned above, its analysis and recommendations are not limited to the UK in their relevance.

However:

- while the use of industry standard documentation and definitions is usual, we believe that it is generally better to allow the industry to develop, maintain and change such standards rather than to risk hardwiring them (and potentially related monopolies) through regulatory requirements; and

- the proposed restriction of permitted derivatives to those used "for genuine hedging purposes" risks having, as a consequence, an increase in legal and accounting costs for the provision of opinions confirming the nature of the derivatives in place, without necessarily protecting against some of the problems that can arise with derivatives. We would suggest that a focus on clear disclosure regarding the use of derivatives might be more effective.

9. Payment priorities and observability

We have no objection to these proposed criteria, save for the one relating to what happens after a performance-related trigger, event of default or acceleration event. In the context of CMBS, investors will often have a say in whether a transaction should be accelerated so they have the opportunity to express support for a restructuring or other remedy. As a result, sequential principal amortisation may only commence after a note event of default and a noteholder vote to accelerate. That flexibility should be preserved.

10. Voting and enforcement rights

We agree with this proposed criterion.

Additional consideration: We do not believe it would be appropriate for criteria to be laid down in relation to the balance of power as between different classes of note holder. The important thing is that the rights of each class are clear so that prospective investors can assess their implications as part of their due diligence. CRE and CRE debt are heterogeneous and non-granular in nature, so there is an important and natural role for CRE specialist investors to take junior notes that carry specific rights (clearly set out in the prospectus and underlying documentation) over work-out of non-performing loans or properties.

11. Documentation disclosure and legal review

We agree with the criteria proposed in this section.

Additional consideration: As noted elsewhere in relation to standardisation, we support the principle, but would prefer to see the industry continue to improve consistency in documentation and disclosure, especially in relation to so heterogeneous and non-granular an asset class as securitised CRE debt.

12. Alignment of interest

We do not object to the principle at which this proposed criterion is aimed, but we note the significant differences in the way different jurisdictions have implemented "skin in the game" provisions to date. Specifically from the point of view of securitised CRE debt, we are aware of problems in the European context around precisely where the regulatory perimeter should lie, but we hope that those can be sensibly resolved.

Additional consideration: It is not clear to us what is proposed here. Where "skin in the game" rules are already in place, we are not sure what additional benefit there would be from introducing a further requirement for a fiduciary party to confirm compliance.

C. Fiduciary and servicer risk

13. Fiduciary and contractual responsibilities

We agree with the criteria proposed in this section.

Additional consideration: As noted in our comment on the additional consideration regarding voting and enforcement rights above, we do not believe it would be appropriate for criteria to be laid down in relation to the balance of power as between different classes of note holder. The important thing is that the rights of each class are clear so that prospective investors can assess their implications as part of their due diligence. CRE and CRE debt are heterogeneous and non-granular in nature, so there is an important and natural role for CRE specialist investors to take junior notes that carry specific rights (clearly set out in the prospectus and underlying documentation) over work-out of non-performing loans or properties.

14. Transparency to investors

We agree with the criteria proposed in this section.

We would be delighted to assist BCBS-IOSCO in further work in this area insofar as it relates to securitised CRE debt (and indeed CRE debt more generally).

Please contact Peter Cosmetatos, CEO, CREFC Europe, at pcosmetatos@crefceurope.org or on +44 (0)20 3651 5696 in the first instance.