Date: 17 September 2021

Targeted consultation on the functioning of the EU securitisation framework

Supplemental submissions of the Commercial Real Estate Finance Council (CREFC) Europe

The Commercial Real Estate Finance Council (**CREFC**) Europe is a trade association promoting a diversified, sustainable and successful commercial real estate (**CRE**) finance market in Europe that can support the real economy without threatening financial stability. Our core membership includes a range of different bank and non-bank lenders, intermediaries and advisory businesses, and real estate firms that use debt to finance their activities. The CRE debt securitisation market is one part of that wider ecosystem.

We should make it clear at the outset that our submissions are made from the perspective of the CRE debt and securitised CRE debt market, although we refer to submissions made by other industry bodies with different perspectives where (as is often the case) our views align.

We should also make it clear that, as an industry association, we seek to represent our market as a whole. Our membership, and our member consultation process, includes investors, issuers, rating agencies, loan servicers, lawyers and others. We have provided responses where we feel we have something to contribute based on our own expertise and the input we have received from members. We do not represent the interests of any specific constituency in the securitised CRE debt market.

Purpose of these supplemental submissions

The European Commission’s online response form no doubt makes the analysis of responses to consultations easier. Unfortunately, it complicates the work of those seeking to make submissions. Character limits are one problem; the fact that only certain multiple choice responses open up the opportunity to provide comments is another. We decided to make this supplemental submission because for a small number of questions we were unable to include our complete responses on the form. We set out those complete responses below.

There were also extensive supporting materials that we wanted to submit to accompany our response. Unfortunately, the Commission’s online response form accepts only accompanying documents that are no larger than 1MB in size. As a result, we included hyperlinks to supporting materials that can be found on our website. We will attempt to submit those supporting materials by email alongside our response. In any event, we would be delighted to provide them to you, and to respond to any questions you may have.

If you have any queries in relation to our submissions or any of those supporting materials, please contact Peter Cosmetatos, chief executive of CREFC Europe, on +44 7931 588451 or pcosmetatos@crefceurope.org.

Question 1.2: If you answered 'somewhat disagree' or 'fully disagree' to any of the objectives listed in the previous question, please specify the main obstacles you see to the achievement of that objective.

The introduction of the SECR did not support the growth of well-structured and robust commercial real estate debt securitisation, and may indeed have had the opposite effect in important respects. There is an opportunity for the SECR review to achieve a better outcome.

As a general observation, we would note that the emergence and growth of European commercial real estate ("**CRE**") debt securitisation in the years immediately leading up to the global financial crisis ("**GFC**") took place very rapidly in the context of the exuberant phase of a CRE cycle. Issuance of commercial mortgage-backed securities ("**CMBS**") began in Europe in 1995, but remained at modest levels before exploding in 2005-07 (the three vintages to which all pre-GFC CMBS losses relate). Losses from those vintages are unsurprising given the collapse in property values that began in mid-2007 (affecting both securitised and unsecuritised CRE debt). While there were undoubtedly lessons for Europe's young CMBS market to learn, the problems with pre-GFC issuance should not be overstated – they were far more a reflection of what happened in CRE and CRE debt markets generally, than a result of weaknesses in the CRE debt securitisation market.

Data from the UK banking sector and CMBS market provide good evidence for that statement (by comparison, the ECB publishes less relevant data for EU banks; indeed, earlier this year we invited the ECB and ESRB to consider making more CRE lending data available to the market to help market participants better understand and manage risks and identify opportunities, but policymakers said they had other priorities and declined to engage with us). Much of the quantitative data referenced in these submissions is sourced from materials we have previously submitted to the European Commission, available here: https://www.crefceurope.org/library/opendownload/249 and in an updated (March 2021) Bank of America research paper on the performance of securitised European CRE loans, available on request.

Of the £14.3bn of CRE loans originated and sold via conduit securitisation by UK banks between 2000 and 2008, only around 4% of principal was written off (and of EUR184bn of CRE loans securitised across Europe over that period, aggregate losses represent 3.7% of the original loan amount). By contrast, UK banks ended up writing off around 10% of the pre-GFC CRE loan principal amounts they originated to hold on their balance sheets. We suspect the figure for EU banks is unlikely to be substantially lower.

Notwithstanding that reality, in designing the new SECR regime, EU policymakers effectively cast CMBS as a villain, even going so far as state in a recital that CMBS (generally) should not be considered to be "simple, transparent and standardised" ("**STS**"). The justification for that approach was the "poor performance of parts" of the pre-GFC CMBS market that resulted from a "strong reliance" for repayment of bondholders on the sale of the underlying assets. The actual performance data for pre-GFC issuance (especially compared to loans originated by European banks to be held on balance sheet) was ignored. So were the ways the CMBS industry itself adapted and improved the product in response to the experience of the GFC (as to which see further below). As explained in our response to Q1.3 below, we do not think it is accurate to describe CMBS as strongly relying for repayment of bondholders on the sale of the underlying assets. Nevertheless, and while Recital 29 does not technically prevent CMBS from being designated STS, the very clear message it sends was not lost on the CMBS market.

The development of the SECR regime thus missed the opportunity for proper engagement with the CRE debt market (both securitised and not), so the application of the SECR regime from 1 January 2019 did not improve access to credit for the CRE market (an important part of the real economy). Far from widening the issuer or investor base, the regime added significantly to the complexities of regulatory compliance and the costs of transactions for issuers and investors, raising the barriers to entry for new issuers and new investors. Perhaps most damagingly, the capital charges imposed by the Solvency II standard formula for market risk on insurer exposures to CMBS are penal, effectively driving a huge pool of potential investment to seek alternative (typically less liquid, transparent or comparable) ways of accessing the risk and returns of CRE debt.

The results can be seen in a European CRE debt market which remains heavily dominated by the banking sector, and a European CMBS market that remains very small; by contrast, the CMBS market in the US has recovered strongly in the years since the GFC, providing levels of liquidity and transparency that we in Europe can only dream of. The SECR review can change these dynamics and send clear signals about the quality of and support for the CRE debt securitisation market by (among other things) improving the regulatory capital and liquidity treatment of CMBS under CRR and Solvency II, as well as eligibility for the purposes of the Liquidity Coverage Ratio and ECB/Eurosystem liquidity operations.

There is a real opportunity under the wider review of SECR and the EU prudential Solvency II and CRR frameworks to allow CRE debt securitisation to play a bigger role in helping institutional capital to support productive investment in the buildings that form the heart of the EU's towns and cities, as well as in growth areas of the real economy such as logistics and the light industrial sector, and buildings for life sciences. A well-functioning CRE debt securitisation market can provide access to credit where banks (themselves affected by post-GFC regulatory changes) do not wish to lend, as well as operating as a vehicle (alongside private syndication) for banks and other CRE lenders to distribute loans they have originated, recycling their capital for further lending to the economy.

CREFC Europe and others in our market have undertaken or supported various initiatives in the years since the GFC to improve the operation of CMBS markets and of CRE debt markets more broadly. In 2012, we published "Market Principles for Issuing European CMBS 2.0", a detailed examination of how weaknesses in CMBS revealed by the GFC might best be addressed (it can be accessed here: https://www.crefceurope.org/library/opendownload/250). We believe the best market and regulatory outcomes can be achieved through constructive dialogue between policymakers and industry.

We set out below additional comments on our responses above that are marked as "fully disagree".

Improving access to credit for the real economy, in particular for SMEs

As outlined above, we "**fully disagree**" that the SECR improved access to credit for the CRE market (an important part of the real economy); indeed, by increasing the cost of CRE debt securitisation and effectively limiting access to STS designation, it may have done the opposite. In particular, we would emphasise that this issue cannot be considered in isolation from the regulatory capital and liquidity treatment and eligibility for central bank liquidity operations of securitised CRE debt. The difficulties around STS designation create distortion within the CRE debt market, meaning that CMBS do not have the benefits of better regulatory treatment associated with such STS designation under CRR, LCR or Solvency II regimes, which remain misaligned in terms of regulatory capital requirements with the true economic risk of securitised CRE debt. The problematic regulatory treatment of CMBS means that Europe's CRE debt market remains overwhelmingly private (with transparency and data challenges that the ESRB and ECB acknowledge, and should engage with us again, as they have done in the past, to address). It also means banks remain the dominant source of credit for CRE, so those parts of the market that are unattractive for banks are underserved, facing unnecessary barriers to being able to attract credit supply from other sources of capital (such as through the securitisation market).

Widening the investor base for securitisation products in the EU

We "**fully disagree**", as noted in our comments above, perhaps most importantly because the effective (in practice, if not technically absolute) exclusion of CMBS from STS treatment has driven insurance capital in particular to access the risk and return offered by CRE credit in different ways, and not through securitisation products. More broadly, we agree with AFME that onerous and detailed investor due diligence requirements prescribed by SECR act as barrier to entry, which does not promote widening of investor base. This is especially clear in the CRE financing market which is overwhelmingly a private loan market: if the cost and complexity of debt investing via the securitisation market is much greater than other, private routes, it will be in relatively rare cases that the sell-side and the buy-side choose securitisation.

<u>Widening the issuer base for securitisation products</u>

As noted in our comments above, from the CMBS perspective, we "**fully disagree**", because the SECR increased the cost and complexity of accessing investors via securitisation as compared to other routes. In combination with the lack of properly aligned regulatory capital and liquidity treatment that could attract a wider investor base, that acts as disincentive for securitisation and does not promote the widening of the issuer base.

Question 1.3: What has been the impact of the SECR on the cost of issuing / investing in securitisation products (both STS and non-STS)? Can you identify the biggest drivers of the cost change? Please be specific.

There are currently no CMBS deals designated as STS in the EU. We consider that the result of a politically rather than policy driven choice, and not reflective of the quality (in terms of their simplicity, transparency or standardisation) of CRE debt securitisation transactions brought to the market since the GFC.

The selection and structuring of investments cannot be viewed in isolation from the regulatory capital and liquidity treatment to which they (and competing investments or structures) are subject. Accordingly, we would emphasise the importance of the prudential treatment and eligibility for central bank liquidity operations for the prospects of a healthy (CRE debt) securitisation market in the EU. Inevitably, CMBS liquidity is affected by the fact that CMBS are not eligible as collateral for ECB/Eurosystem liquidity operations and because better regulatory treatment is not available for European CMBS (largely because of the effective lack of access to STS designation).

The absence of STS CMBS deals is clearly linked to Recital (29) SECR, which expressly states that CMBS should not be considered as STS securitisations because of the "strong reliance" of the repayment of securitisation positions on the sale of the assets, referring in this regard to the "poor performance of parts" of the CMBS market during the financial crisis. Related EBA non-ABCP STS guidance further notes (in respect of the STS criterion that there should be no predominant dependence on the sale of assets) that "it is expected that commercial real estate transactions […] would not meet these requirements, as in all these cases it is expected that the repayment is predominantly reliant on the sale of the assets, that other possible ways to repay the securitisation positions are substantially limited, and that the granularity of the portfolio is low".

Those assertions are fundamentally wrong. It is true that most CRE loans involve no more than modest levels of amortisation, so that most or all of the principal advanced at the outset has to be repaid at loan maturity. But the CRE finance market does not rely predominantly on sale of underlying assets to repay loans at maturity – it relies on refinancing, with new credit being advanced (whether from the same or a different source) to repay the existing loan. When a loan matures in conditions of severe market stress, after a property market crash or when credit markets are closed, there may be no alternative but to sell assets (even into a weak market) – although a sale would typically be the last resort (in the securitisation context as it is in the CRE loan market), following failure to refinance or otherwise resolve the loan. Addressing that risk is precisely why one of the changes that the CMBS market implemented post-GFC was to introduce much longer tail periods between loan maturity and the legal final repayment date of the bonds. It is also a risk that reduces with a greater and more diverse pool of potential CRE debt investors (it should be remembered that investors who purchased CMBS notes at the temporarily steep discounts at which they traded in the illiquid depths of the GFC did very well). We would be interested to see the evidence behind the assertion that CRE transactions generally rely on the sale of the assets to repay CMBS bonds.

In addition, Article 243 CRR establishes a maximum concentration limit for “exposures to a single obligor” which directly precludes improved STS capital treatment for almost all CMBS. This too is based on a misunderstanding of the credit risk and credit analysis of CRE debt. Unlike retail loan securitisations where the underlying loan and the credit exposure are to individual obligors, in the CRE context the loan may be to a single property-owning obligor, but the credit exposure is to the underlying tenants paying the rent that ultimately services payments on the notes. It is misconceived to regard a securitisation of, say, a loan secured on a single shopping centre with a hundred business tenants, or a loan secured on an apartment complex with 500 residential tenants, as exceeding concentration limits because there may just be a single obligor. However, that is how the rules were written. This review is a good opportunity to correct that error.

Recital (29) and other aspects of the STS framework’s ‘defences’ against CMBS are unfortunate for a number of reasons:

- They misrepresent and misunderstand the performance of CMBS pre-GFC (see Bank of America research referenced/linked above);

- they ignore CMBS structuring changes adopted by the industry in response to the experiences of the GFC (including in particular the use of longer tail periods between loan maturity and legal final maturity of the notes, to reduce the risk that refinancing or asset sales might have to take place during a period of temporary market disruption or illiquidity) – precisely so that CMBS noteholders’ repayment does not depend predominantly on the sale of assets securing the underlying exposures;

- they fail to recognise that, in the context of CRE, diversification of credit risk should be assessed at the level of the tenants of the underlying real estate, where the true credit exposure is located, and not by reference to the number of loans or obligors;

- further on the diversification point, they ignore the fact that a single, very strong covenant (such as a government body) in a CRE investment can be a better credit risk than a large number of obligors or tenants (which may, despite their ostensible diversity, behave in correlated ways in challenging economic conditions); If this is something that the CRE industry and bank lenders routinely recognise and reflect in underwriting and pricing, why should regulation effectively prevent the securitisation market from doing so? and

- the general nature of Recital (29) – but also the associated guidance referenced above – runs counter to the criteria-based approach to determining STS status in the operative provisions of the Sec Reg itself, which encourages the interpretation and application of Article 20(13) on a transaction-by-transaction basis.

The strong discouragement against seeking STS designation for CMBS transactions puts such deals at a competitive disadvantage compared to other securitisation sectors when it comes to regulatory capital treatment, with implications for pricing.

As noted above, liquidity of an investment is very important and LCR eligibility as a key driver for bank investors. It is therefore extremely unhelpful that LCR eligibility currently turns on STS designation, is limited to certain asset types and excludes non-STS (and thus, to all intents and purposes, all) CMBS entirely. We would encourage the European Commission to consider expanding the LCR framework so that certain AAA-rated non-STS securitisations (which should include performing CMBS) are also eligible as Level 2B assets. Should the EU STS regime be adjusted to better accommodate CMBS, as we recommend, this should in turn be appropriately reflected in the treatment of STS CMBS under the LCR regime.

The difficulty around STS designation also creates a distortion within the CRE debt market for insurers subject to the standard formula for market risk under Solvency II and we refer in this regard to further comments included in section 15 on Solvency II. We also refer again to the evidence-based representations we had submitted to the European Commission in late 2017 and early 2018 about why the Solvency II approach to CMBS cannot be objectively justified: https://www.crefceurope.org/library/opendownload/249). Perhaps this review is the opportunity for a considered policy response.

We have mentioned above the efforts made by the CRE debt securitisation industry to address weaknesses revealed by the GFC in post GFC issuance (often called "**CMBS 2.0**"), such as the substantial extension of the tail period between loan maturity and legal final maturity of the bonds to reduce the risk that repayment of noteholders will be affected by a period of temporary market stress or illiquidity. The best reference point for those efforts is our work with industry participants to develop recommendations and standards for post-GFC CMBS issuance, including "Market Principles for Issuing European CMBS 2.0" which was mentioned above (and is accessible here: https://www.crefceurope.org/library/opendownload/250). Many of the recommendations in CMBS 2.0 have been widely adopted for post-GFC CRE debt securitisation, in a way that regulators might usefully have recognised – and could now choose to recognise – as best practice (simple, transparent and standardised) for the asset class.

It did not take the GFC for the CRE debt securitisation industry to recognise the importance of consistent and detailed investor disclosures. Long before the GFC, our sister organisation in the US developed an investor reporting package for the CMBS market (https://www.crefc.org/irp/) which we and our members adapted for use in the European market (the European Investor Reporting Package, or "**E-IRP**"; for further information, go to: https://www.crefceurope.org/committee/10). We were disappointed that European regulators did not work with us to adapt the ECB's template (which had itself been informed by our E-IRP) when it came to the development of ESMA's disclosure templates. But while our investor reporting framework has been displaced by regulatory disclosure requirements, it should be remembered that the CMBS market recognised the need for good quality investor reporting on its own, and developed the templates required to deliver it without regulatory assistance. We do acknowledge that aspects of the EU's post-GFC regulatory framework such as risk retention requirements have also supported the responsible and sustainable evolution of the market.

The fact that some pre-GFC CMBS (also termed "**CMBS 1.0**") defaulted and that some investors (including in investment grade tranches) lost money does not justify the effective blanket exclusion of the entire asset class from STS designation. Securitised CRE loans performed much better than CRE loans held on bank balance sheets, as reported by the research cited above.

In the March 2021 research paper mentioned above, Bank of America also reported "evidence that the lessons learned from defaults in CMBS 1.0 may be helping to minimize defaults in CMBS 2.0 transactions", noting that the main problem behind defaults in post-GFC CMBS issuance seems to be underlying collateral comprising "retail property of less-than-prime quality". This, again, is a structural challenge facing the retail property market and those providing debt and indeed equity to it in any form; it is not reflective of weaknesses particular to CMBS.

Of the current position, Bank of America say that: "despite the pandemic, CMBS loan defaults have been limited and performance has been better than occurred during the financial crisis. We attribute this relative success to improvements in CMBS 2.0 and efforts on the part of servicers to avoid defaults this time." They recommend implementation of certain of the recommendations of a 2014 report, "A Vision for Real Estate Finance in the UK" which was produced by an independent industry group with the encouragement of the Bank of England and sought to promote CRE finance markets that provide credit to the real economy without presenting unacceptable risks to financial stability.

The Vision report can be accessed here: https://www.crefceurope.org/library/opendownload/47. We have previously shared it with officials at the ESRB, ECB and European Commission, as many of its recommendations are as relevant to EU markets as they are for the UK. For example:

- recommendations 1 and 2 advocate much better CRE debt market data and analytics for policymakers and market participants alike;

- recommendation 4 argues for the development and adoption of long-term value methodologies in relation to underlying CRE collateral, to reduce the risk of irrational exuberance among lenders during a property boom; and

- recommendation 6 argues that policymakers should positively promote diverse sources of CRE credit supply as a means not only of reducing CRE risk within the banking system, but also of enhancing the resilience of the CRE debt market as a whole.

We have been disappointed at the lack of interest among EU policymakers in exploring those recommendations with us (most recently, in the refusal of the ESRB and ECB to work with us on improving data availability for market participants). Rather than effectively restraining the CMBS market, policymakers concerned about the role of CRE credit (whether in threatening financial stability or in promoting productive investment in the real economy) might usefully read the Vision report and develop a more consistent dialogue with relevant industry bodies like CREFC Europe.

Standards & Poor's also observed in the aftermath of the pandemic that led to cash flow disruptions in European CMBS transactions backed by the hard-hit retail and hotel sectors that "unlike in U.S. CMBS, European CMBS liquidity support features generally mean that absent any restrictions or caps, junior classes of notes will continue to access liquidity support … we do not expect a lack of liquidity support to lead to as many note-level interest shortfalls as during the great financial crisis due to the changes made to the mechanics of liquidity support" (see S&P's reports "European CMBS: The Lowdown on Liquidity Support" from November 2020, and "European CMBS: Assessing the liquidity risks caused by Covid-19" from May 2020; other rating agencies agree, such as KBRA in its report "Sponsor support and structural features insulate UK CMBS from rent disruptions" from April 2020).

A better informed and more nuanced regulatory approach to the regulation of CRE debt securitisation, including to the scope for CMBS transactions to qualify for STS treatment, could provide real benefits to both the real economy and capital markets in the EU. We would be delighted to provide the European Commission and the EU supervisory authorities with further information and to engage in a constructive dialogue in this area.

There has been an increase in both the costs of issuing and investing in CMBS. Since the GFC, CMBS 2.0 moved away from the pure "originate to distribute" model that was previously the norm and, for a number of years, pre-2019 CMBS adopted better market practices based on lessons learned, including better disclosure and reporting that followed recommendations and standards developed by the industry via CREFC Europe (see reports and initiatives referenced above).

These best practices for CMBS 2.0 were not properly taken into account for the purposes of CMBS reporting requirements under SECR. For example, loan-level reporting under SECR was derived from ECB templates. While the ECB had based its CRE templates on the E-IRP industry standard, the fact that CMBS has not been ECB eligible means that a dialogue with the industry would have been a more effective way of ensuring that new SECR CMBS reporting requirements are fit for purpose. Working with formats, templates (and sometimes terminology) developed by regulators with only late and limited scope for industry input gives rise to significant upfront and ongoing costs. That, in turn, affects both:

(i) the CMBS sell-side that needs to produce information required under SECR, as well as to continue preparing certain additional reporting based on established market practices (such as special servicer reports) – which means that engagement of multiple agents to facilitate compliance is needed on most CMBS, which further drives increased costs; and

(ii) the buy-side that needs to review lots more information made available to them than ever before (not all of which is of real value).

The application of onerous and highly prescriptive SECR regime, coupled with the lack of regulatory capital benefit under CRR and Solvency II, creates disincentives to issue or invest in CMBS and impact on pricing of those CMBS that are issued. A deeper and more liquid CMBS market would lead to more efficient pricing on deals, which in turn would result in more efficient pricing in the financing available to investors in the European CRE market more generally.

Question 6.5 a): Do you agree that these asset specific disclosures should become part of a general sustainability disclosures regime as EBA is developing?

No. Securitisation is a very small part of the overall CRE debt landscape, with the large majority of European CRE debt held on bank balance sheets (or by non-bank lenders, often on behalf of the same institutional investors that might have gained exposure to CRE debt via CMBS). Due to its limited scale, Europe's CMBS market cannot provide the transparency, liquidity and comparability of the US CMBS market. Imposing sustainability disclosure requirements on CMBS that do not also apply to CRE loans held on bank balance sheets, for example, would probably add to the barriers that make the growth of European CMBS challenging (and it would not have a material impact on the sustainability information available in relation to European CRE debt).

We also think that any mandatory requirements for additional asset-specific disclosure should apply only to securitisations (including CMBS) which are marketed as ESG. To the extent that additional ESG-related information is required by a particular investor or group of investors in any CMBS transaction that is not specifically marketed as ESG, we would expect the market to be able to ensure appropriate disclosure without regulatory intervention: the sell-side parties should be able to respond to investor-driven disclosure demands on a case-by-case basis with appropriate additional disclosures, particularly as the basis for marketing a deal as ESG is likely to vary significantly from transaction to transaction in the CRE context.

Question 6.5 b): Should ESG disclosures be mandatory for (multiple choice accepted):

Securitisation that complies with the EU green bond standard.

We support the submissions of AFME in relation to this question and note that, from the perspective of securitised CRE debt, until the wider CRE market and CRE lending markets settle on appropriate disclosure frameworks, securitised CRE debt should only be subject to mandatory ESG disclosures if the relevant bonds are specifically marketed as ESG compliant (including under the EU green bond standard), and not by virtue of their securitised status.

Question 15.1: Is there an appetite from insurers to increase their investments in securitisation (whether a senior tranche, mezzanine tranche, or a junior tranche)?

We responded "yes" to this question, but were not able to add an explanation. Please see our responses to Q15.2 and Q15.3.