RESPONSE TO

A Vision for Real Estate Finance in the UK

Draft Recommendations by a cross-industry real estate finance group

An industry discussion

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BY

Commercial Real Estate Finance Council®
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1. INTRODUCTION AND BACKGROUND

We welcome the opportunity to comment on the report of October 2013 entitled "A Vision for Real Estate Finance in the UK – Draft Recommendations by a Cross-Industry Real Estate Finance Group" (the "**Vision Report**").

The Vision Report is a valuable contribution which we strongly endorse. We have also been pleased with the high level of interest it has provoked across our membership and the industry.

This paper has been prepared by a working group formed by the Commercial Real Estate Finance Council ("**CREFC Europe**") to respond to the Vision Report. The working group has in turn benefited from input from others in the CREFC Europe membership and beyond.

1.1 CREFC Europe

CREFC Europe was formed in July 2004 and plays an active role in the commercial real estate ("**CRE**") finance marketplace. It was originally formed by the United States-based Commercial Mortgage Securities Association ("**CMSA**") to support the growth of the commercial mortgage backed securities ("**CMBS**") market in Europe. Since then, the CMSA has become the Commercial Real Estate Finance Council (CREFC) and redefined itself to work across all aspects of the CRE finance market. The London-based CREFC Europe is now fully independent of CREFC in the US, although we maintain strong ties and continue to collaborate.

Our mission is to promote efficient, liquid, transparent and sustainable markets in CRE debt. We develop best practice guidelines, provide education and training for our industry and facilitate collective regulatory engagement. We want investors to have an appropriate range of opportunities to gain exposure to CRE risk and returns, and CRE borrowers to have appropriate access to the credit they need so that the CRE sector can deliver its contribution to society and the wider economy.

1.2 The CREFC Europe Working Group

The Working Group established by CREFC Europe to respond to the Vision Report comprises 15 representatives, each with substantial experience of commercial real estate finance. These representatives include Andrew Carnegie of Clifford Chance, Paul Dittmann of M&G Investments, Conor Downey and Charles Roberts of Paul Hastings LLP, Dale Lattanzio of DRC Capital, Jacqueline Macleod of Hatfield Philips International, Rahul Sule of J.P. Morgan and Caroline Philips. Additionally, there were representatives from other institutions, including Brookland Partners, CBRE Loan Servicing and Morgan Stanley.

2. RESPONSE TO THE VISION REPORT

We support the objectives, approach and Recommendations presented by the Vision Report, subject to only some reservations about Recommendation 2 (*Expert Group*).

2.1 We would like to comment in particular on three specific aspects of the Vision Report:

2.1.1 Recommendation 1 of the Vision Report (*Loan Database*). We provide additional comments on this in Section 3 of this paper.

2.1.2 Recommendation 6 (*Promoting Diversity*). We regard this as being linked to Recommendations 4 (*Long Term Sustainable Value*) and 5 (*Risk Differentiation*) of

the Vision Report. In Section 4 of this paper, we present a number of ideas on how to increase the diversification of funding sources of CRE debt in the UK.

2.1.3 Encouraging a safer market structure via the equity side of CRE, as to which we have made further suggestions in Section 5 of this paper.

2.2 We would also make the following specific observations:

2.2.1 Recommendation 3 (*Education*): We question whether imposing educational requirements on lenders is likely to materially change behaviour through the property cycle. However, imposing educational requirements could provide a useful conduit for disseminating information and best practice, which we recommend below, across the lending market.

2.2.2 Recommendation 2 (*Expert Group*): We question whether creating a committee of industry experts is likely to materially reduce systemic risk through the property cycle. On the other hand, we see a risk that having such a committee could alleviate in part the government's responsibility to set policy. Overall, we think policies work best when they operate automatically rather than requiring anyone to decide the time is right to pull a particular lever (in line with the Vision Report's preference for governors over switches).

2.3 In this paper, we refer generically to "regulators", "regulatory framework", etc. Clearly, different parts of the CRE debt market are regulated in different ways (and some not at all). We also note that regulatory treatment and regulatory capital requirements are not the sole drivers of market appetite for new lending and investment. However, we have analysed this in full in this paper in the interests of brevity. We can provide more detail on this if this would be helpful.

3. LOAN DATABASE

3.1 We agree with Recommendation 1(*Loan Database*) for the reasons outlined in the Vision Report. A further benefit would be to address the transparency arbitrage between loans in the CMBS market (which are subject to substantial reporting obligations), loans by banks (which are subject to modest reporting obligations) and loans by other lenders (which may be subject to few or no reporting obligations). Overall, better market information would support greater liquidity in CRE debt markets, which would be a good thing.

3.2 As a starting point, the European Investor Reporting Package ("**E-IRP**") created by CREFC Europe is in use in the industry as a CRE loan reporting template in the CMBS context. The E-IRP template was used by the ECB in defining its loan level reporting requirements. CREFC Europe would be willing and is well placed to lead an industry collaboration to design an appropriate reporting template for the centralised loan database. It should if possible be consistent with the E-IRP template, so that existing information systems can be adapted to deliver information for both purposes.

3.3 Possible enhancements to the E-IRP might include additional provision of rent roll data for commercial property collateral. A list by unit of tenants, break dates, lease end dates, rent review dates and types along with current rent and ERV would complete the picture for risk assessment and analysis, although data protection and confidentiality issues would have to be considered in this regard.

3.4 We agree that compliance should be mandatory. The reporting requirement at origination could be enforced by making compliance a prerequisite to registering a mortgage in the UK. However, it is not clear how compliance might effectively be enforced among overseas and unregulated lenders or purchasers of CRE debt.

3.5 We agree that as much information as possible should be publicly accessible, provided that confidentiality is maintained about individual assets, borrowers and lenders.

3.6 While the creation of a central loan database could (and probably should) be carried on in a commercial way, it is important that the provider or 'owner' of the data repository is not in a competitively privileged position as compared to other analysts, observers etc. when it comes to using the data to provide value added services. In other words, simply running the warehouse should be a fundamentally administrative and reasonable margin business. It should operate as a utility, with both the provider of the database and third parties, including commercial information providers, having equal access to provide commentary, manipulate the data, run stress tests and conduct risk analysis.

3.7 The database provider should be accountable both to the regulator and to the industry. Accountability to the industry in a regulator-friendly way might best be achieved by giving governance oversight over management of the database to a non-profit industry body with CRE debt information expertise such as CREFC Europe.

4. DIVERSIFICATION OF FUNDING SOURCES

We make several recommendations for increasing the diversification of funding sources of CRE debt in the UK through (i) the creation of new transparent, high quality CRE loan and bond products based on best practice industry standards, and (ii) addressing conditions that currently give banks an advantage over alternative lenders.

4.1 Creating a new high quality CRE loan product

We recommend working with the relevant regulators to create a prescriptive set of origination criteria. CRE loans conforming to those criteria would be recognised as safe and thus qualify for formal and official endorsement, including through regulatory capital requirements (consistent with Recommendation 5 (*Risk Differentiation*)).

4.1.1 The criteria would be simple, transparent and objective and might for example include the following:

(a) Specified criteria for mortgage and other security;

(b) Minimum due diligence requirements; and

(c) Minimum reporting requirements for borrowers (potentially set at a higher level than those applying across the industry, for example reflecting E-IRP).

4.1.2 Compliant loans would be identified with a quality assurance brand (a "**Kitemark**"). Ideally the regulator would endorse the brand by granting conforming loans preferential regulatory capital treatment reflecting their low risk. For example, compliant loans should justify more favourable treatment than is currently available to "strong" loans under "slotting".

4.1.3 CREFC Europe would be willing and is well placed to lead the initiative to draft a standardised loan agreement document (as referred to in Section 4.1.1(j)) in collaboration with other relevant trade bodies and other industry participants.

4.1.4 Also, CREFC Europe would be willing and is well placed to perform the role of providing governance, policing compliance and issuing Kitemarks (similar to the way AFME regulates other types of securitised products).

4.1.5 Lenders would pay a fee to the body that polices the Kitemarks in return for the issuance of Kitemarks for their loans. After allowing for the costs of operating the Kitemark regime, this fee income would be passed on to borrowers. However, if Kitemark loans were to be treated as suggested in Section 4.2.13, the Kitemark should also reduce loan margins for borrowers and, as such, the total cost to borrowers should be attractive when compared to other forms of finance.

4.1.6 The benefits of such a system would be as follows:

(a) It creates a transparent, liquid CRE loan product;

(b) It lowers the barriers to entry for new regulated lenders;

(c) It makes data reporting easier;

(d) The transparent and officially sanctioned Kitemark would replace reliance on credit ratings for bond products underpinned by Kitemark loans (see further Section 4.2 below); and

(e) Compliant loans should convey a lower rate of interest to borrowers net of the cost of compliance, which could be incorporated into the loan margin.

4.1.7 Compliance with this system should be voluntary. The incentive is the lower cost to both borrowers and lenders and, it is hoped, the appetite from investors in bond products underpinned by Kitemark loans (which should in turn further reduce costs).

4.1.8 We envisage that Kitemark status would be applied for at the time of origination. It is unclear whether it would be practical or desirable to review the status thereafter[1].

4.1.9 Capital markets products such as CMBS and listed debt funds would be natural investors in Kitemark loans, which would increase the diversification of funding. Listed debt funds could invest either directly in the Kitemark loans or indirectly in a bond comprised of Kitemark loans.

4.1.10 It may be worth considering giving regulated lenders and investors in Kitemark loans portfolio-level capital relief for diversification by loan size, geography, borrower,

[1] By way of comparison, the Pfandbrief rules require revaluation where there is good reason to expect property values to have fallen, particularly where there is evidence of a general market decline. Where a revaluation shows a decline in value, the loan remains eligible but funding is available only for the 60% (long-term sustainable value-based) LTV tranche. Also note that German banks typically set LTVs on Pfandbrief some way below 60% to allow a little room for market fluctuations in value. There are suggestions that German banks are not diligent in revaluing loans which might be expected to be in LTV default.

asset type, etc., although the historical benefit from such diversification during previous downturns should be reviewed.

4.2 Creating a new high quality CRE bond product

4.2.1 It is likely that Kitemark loans may be attractive for existing capital markets products like CMBS. However, we recommend the creation of a new bond product ("**Qualifying CRE Bonds**") to tap into the potential demand we see amongst a new group of investors who want a CRE debt product with lower risk that is packaged as a listed security.

4.2.2 Conceptually, the credit risk on Qualifying CRE Bonds would be intended to be equivalent to a debt carrying an AAA credit rating. Criteria would be established as to the types of commercial real estate loans that could be contained in a CMBS that issues Qualifying CRE Bonds. A Kitemarked Loan would be a qualifying asset without having to meet any other qualifying criteria for a Qualifying CRE Bond.

4.2.3 Whether or not such Qualifying CRE Bonds are also rated by any rating agency, the relevant regulator should endorse the implied AAA quality of these Qualifying CRE Bonds by making them eligible for its repo/discount window on terms that reflect that implicit rating and/or through other incentives. That would support the emergence of a more liquid market in Qualifying CRE Bonds, in turn improving their attractiveness to investors and lowering the cost of credit which is fundamentally very low risk. Classifying Qualifying CRE Bonds in this way would provide "back-stop" liquidity for the market in Qualifying CRE Bonds which would greatly assist in the development of this market.

4.2.4 Qualifying CRE Bonds would be characterised by high credit quality, low leverage, high liquidity and a correspondingly low yield.

4.2.5 Criteria would be established as to the structural requirements for the Qualifying CRE Bonds, which might consist of the following:

(a) Static pool of commercial real estate loans;

(b) Minimum liquidity requirements in the event of payment shortfalls on the underlying commercial real estate loans;

(c) Control servicing of the loans by the issuer of the Qualifying CRE Bonds; and

(d) Minimum reporting requirements for the Qualifying CRE Bonds (i.e., CREFC E-IRP Investor Reporting Package).

4.2.6 The benefits are as follows:

(a) This would create the liquid, low credit risk, transparent CRE debt product that the UK lacks;

(b) The product borrows some beneficial features of Pfandbrief covered bonds but has the advantage (from the point of view of systemic risk) that the arranging bank does not retain the CRE risk as is the case with covered bonds;

(c) Being in a listed bond format increases the product's saleability to a broader investor base than that of loans;

(d) The quality of the underlying Kitemark loan pool obviates reliance on credit ratings;

(e) This product can be used to encourage fixed rate borrowing on longer tenors;

(f) If structured as a single tranche product, the proposed Qualifying CRE Bonds would deliver the simplicity and transparency investors want, and would not be subject to the regulatory disadvantages of securitisation products.

4.2.7 It may be worth considering giving regulated lenders and investors in CRE Bonds portfolio-level capital relief for diversification by loan size, geography, borrower, asset type, etc., although the historical benefit from such diversification during previous downturns should be reviewed.

By creating new products, such as the transparent, high quality Kitemark loans and CRE Bonds described above, that are simpler to understand and more liquid than existing CRE debt products, we hope to attract investment from new sources of debt finance, improving diversity and thus resilience while also encouraging the development of a more stable, low risk and sustainable flow of credit to the CRE sector across the cycle. Regulatory support for such new products would be vital, however, if they are to take root.

4.3 Address imbalances between competing sources of finance

Historically, banks enjoyed an economic advantage over alternative lenders in the UK by virtue of their access to relatively cheap finance in the wholesale funding markets and their comparatively low regulatory capital charges to hold CRE loans. As a result, alternative sources of debt funding have struggled to grow, banks have dominated the CRE lending market, and banks have had little incentive to distribute CRE risk outside the banking system. That has of course changed with the introduction of slotting, which puts UK banks at a relative disadvantage as regards lending to parts of the CRE market (including in particular the very safe end).

The wider current regulatory environment gives preferential treatment to some CRE products, such as bank loans and covered bonds, while making other products, such as securitisation bonds, comparatively more expensive for borrowers and investors. This system does not encourage diversity or support financial stability, because bank loans and covered bonds remain in the banking system. In loan syndications, large exposures often remain within the banking system because many debt investors are unable to own loans and can only own listed securities.

We believe that there is an important role to be played by the capital markets in supporting the flow of credit for the CRE industry. Not only could effective capital markets instruments substantially improve diversity; they could do so in a way that specifically eases the regional and small loans challenge, by creating a framework through which institutions with a national branch network could originate CRE debt on a transparent, consistent and safe basis for distribution to investors.

Unfortunately, current regulatory rules are not friendly to traditional CRE capital markets debt products. For instance, securitisation products are put at a disadvantage to bank loans and covered bonds by the applicable capital charges under Solvency II, the 5% retention requirement, the cost of

monitoring and reporting, and the increased cost of liquidity facilities under CRD2, which are needed by securitisation transactions.

4.3.1 Publically issued CMBS

(a) The unfavourable perception of CMBS, particularly among regulators, is in our view excessively negative. It has been refreshing to hear more positive comments from the Bank of England in recent weeks.

(b) The principal issue with historic CMBS was the poor credit quality of the loans which were the subject of transactions at the top of the cycle, rather than the securitisation technology itself.

(c) The European CMBS industry has already taken steps to ensure that new CMBS issuance will be a better product that historic issuance. In particular we would point to the CMBS 2.0 initiative promoted by CREFC Europe which has been widely adopted in the market for new European CMBS.

(d) We would expect the recommendations presented above (for the creation of a new high quality CRE loan product and a new high quality CRE bond product) to increase the diversity of CRE debt supply with positive implications for CMBS as well.

4.3.2 Listed public debt funds

(a) Listed public CRE debt funds attract a broad range of investors beyond those likely to act as lenders or CMBS investors, by virtue of being packaged as an equity instrument (as opposed to a loan or a bond).

(b) As a result, they help to diversify the funding sources for CRE debt beyond lenders and fixed income investors.

(c) We recommend the regulator consider offering tax relief for certain qualifying listed public debt funds (for example, a sub-set of the kinds of entity that can qualify as mortgage REITs in the United States).

4.3.3 Covered bonds

(a) Covered bonds have proven to be a relatively stable source of finance for CRE in other countries and may be worth considering in the UK.

(b) In Germany, the depth of the covered bond market resulted in funding returning for CRE relatively quickly during the financial crisis.

(c) We see potential benefits for banks to issue covered bonds as follows:

(i) To diversify their capital funding base;

(ii) To help address the bank's term funding mismatch; and

(iii) Covered bonds benefit from advantageous capital treatment from regulators.

(d) However, covered bonds also have the following disadvantages and, overall, we think the regulator's objectives may be better achieved by other products such as the Kitemark loans and Qualifying CRE Bonds described above as well as listed debt funds and CMBS.

(i) Issuing covered bonds does not remove the CRE risk from the banking system as the loans remain with the bank;

(ii) Covered bonds increase the bank's asset encumbrance and leverage and leave depositors with less credit protection;

(iii) Covered bonds are not transparent with little disclosure being provided to investors as to the underlying loan pools;

(iv) Covered bonds are a rated product, dependent in part on the rating of the issuing bank resulting in banks being unable to issue in some cases when down-graded;

(v) Banks with covered bond programmes may be incentivised to make new loans where market conditions would otherwise dictate against new lending to avoid triggering rapid amortisation of their programmes;

(vi) These factors suggest that covered bonds may not be positive for systemic risk.

4.4 **Regulatory obstacles**

Regulatory uncertainty is an obstacle to new investors. It is unclear what the combined effects are likely to be from Slotting, Basel 3, Solvency II, AIFMD, EMIR, CRD 2 (etc.), and proposals to regulate the shadow banking sector.

We note that foreign banks operating in the UK through a branch (as is common) are not generally subject to the same regulatory regime as UK banks. Clearly where a foreign lender is able to make cheap, high LTV, 'covenant lite' loans, they may gain large market share at the expense of local banks, which could leave the UK property market with limited supply of debt financing when the market turns and the foreign banks cease lending. A further consequence of this is that UK banks can be compelled by this to either to compete, thereby increasing the overall risk profile of the industry as margins and credit quality is pushed down, or to withdraw from the market for a period decreasing the diversity of funding sources. EU law as to matters such as the free movement of capital restricts the powers of UK regulators in respect such activities. However, achieving true diversity of UK CRE funding sources would seem to require that the UK regulator have at least some ability to influence the behaviour of foreign lenders. A clear way of achieving this would be to impose similar regulatory requirements on foreign banks lending into the UK to those that apply to UK banks, regardless of whether they operate through branches or subsidiaries. We are aware that such proposals are under discussion in various contexts already.

4.5 **Undesirable new products**

Finally, we would point out that unless steps are taken to address the current lack of diversity of funding sources for CRE debt, there is a risk that excess liquidity in the banking system and the hunt

for yield by investors may well lead to the creation of undesirable new products, if steps are not taken to promote more appropriate new products.

One example may be the recent emergence of retail bonds, some of which have been issued by UK CRE businesses, that are usually unsecured and often have high LTVs.

5. RECOMMENDATIONS RELATING TO THE EQUITY LANDSCAPE

5.1 Prudent Borrowing

Borrowers must bear some responsibility for their excessive borrowing in the previous cycle.

Consideration might usefully be given to capping or tapering the tax deductibility of loan interest at a certain level for borrowers. This proposal is clearly not uncontroversial and would raise serious challenges in implementation and transition. Further analysis and consultation would be required to ensure it does not create other adverse consequences for real estate investment generally.

5.2 Longer Maturities

Borrowers should be encouraged to take longer fixed rate loans (which would be attractive to insurers/pension funds) via incentives at the loan level.

The proposed Qualifying CRE Bonds (described above) would probably encourage borrowers to take longer fixed rate loans through lower interest rates.

Borrowers would be more willing to borrow on longer terms if early prepayment charges typically associated with fixed rate loans can be eliminated by:

5.2.1 HMRC providing guidance on the tax treatment of defeasance mechanisms; and

5.2.2 Allow greater flexibility to 'change of control' and KYC provisions to allow stapled financing on property sales.

Defeasance is a mechanism commonly seen in the USA whereby borrowers collateralise their loans with cash or high grade investments in place of the real estate, leaving them free to dispose of the real estate. Stapled finance describes how a borrower can sell a property (or a property owning entity) without having to repay the associated loan. The result is that the purchaser of the property "inherits" the loan, steps into the shoes of the borrower and becomes responsible for servicing and repaying the loan. This would seem to be a possibility as most UK CRE finance is made on actual or effective limited recourse terms, where the sponsor provides no real credit support.

5.3 Transparent Reporting

Borrowers prefer the least onerous reporting requirements, all else being equal, which is clearly bad for transparency.

In the past, borrowers could minimise their reporting requirements by borrowing from bank lenders (although those requirements could become more onerous, sometimes unexpectedly, if the bank securitised the loan and the loan servicer began thereafter to enforce reporting requirements more strictly than the bank had initially).

In the future, the Vision Report and our recommendations should result in borrowers facing consistent reporting requirements whether they borrow from a bank lender or alternative lender.

5.4 **Valuation Practice**

We recommend that borrowers should have no involvement in property valuations used to secure financing (other than to provide key information), although we see no problem with allowing borrowers to rely on a lender's valuation for their own reporting.[2]

Where borrowers are able to influence valuations (or lender perceptions of valuation), this can increase volatility in property prices and lending risk.

This should be prescribed in the RICS Red Book as industry practice, to address the risk that some lenders or types of lender may be more flexible to arbitrage the market.

[2] We understand that in the US, not even the lending team within a lending institution may select and instruct the valuer: it provides a list of potential valuers to a different, impartial in-house team, which proceeds to select and instruct a valuer from that list, before informing the lending team of the value.