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With copies to: Sharon Bowles, MEP
Syed Kamall, MEP
Peter Skinner, MEP

21 January 2014

Dear Sirs,

Solvency II and securitisation – the real estate perspective

Our organisations would like to comment on the Technical Report on Standard Formula Design and Calibration for Certain Long-Term Investments (EIOPA/13/513) which was published on 19 December 2013 (the **Report**). More information about our organisations is set out in the Appendix to this letter.

Recommendation

We would encourage EIOPA to allow room for certain commercial mortgage backed securities (**CMBS**) to qualify for 'Type A' capital treatment, by reference to objective, qualitative criteria, and not to condemn all CMBS, regardless of their actual characteristics, to 'Type B' treatment. Doing so would promote valuable diversification at two important levels:

- in the investment portfolios of insurers, where CMBS have different investment characteristics from other forms of exposure to CRE and CRE debt (and indeed from other asset backed securities); and

- in the constitution of the CRE finance market, which has historically been excessively reliant on banks and the limited range of products they are willing to keep on their balance sheets, to the detriment of financial stability.

Following our recommendation would also reward industry efforts to address the problems that affected CMBS before the crisis, so that a better product can emerge in the future.

We would be happy to work with officials on the development of appropriate criteria.

Comments

We strongly support EIOPA's initiative to conduct a thorough and considered review of the treatment of securitisation bonds in general (among other long-term investments) under Solvency II.

In recent months, a growing number of policymakers and financial regulators have recognised that securitisation has an important role to play in supporting the long-term financing of the economy. For example, we understand that the International Organisation of Securities Commissions plans to establish a working group dedicated to facilitating the growth of securitisation markets. We agree that the problems that afflicted elements of the securitisation market (especially US subprime mortgages, as the Report notes) during the financial crisis do not mean the baby should be thrown out with the bathwater.

However, we are troubled by the impact that the revised approach proposed by EIOPA will have on insurers' ability to invest in ways that make sense economically and commercially, on the CRE industry and its ability to serve the wider economy, and ultimately on financial stability.

We are particularly concerned that the capital treatment for CMBS is now set to be even worse than previously proposed. We accept that a trade-off has to be made between simplicity and fairness (and recognise the appeal of simplicity), but we do not consider it appropriate for all CMBS to be classified as higher risk, higher cost 'Type B' securitisation. CRE debt has characteristics that make it a highly appropriate component of diverse insurer portfolios, because it generates long-term, inflation-protected cash flows benefiting from security. CMBS in particular can deliver stable, long-term returns with greater risk diversification and liquidity and lower overhead costs than direct CRE lending, while also allowing insurers to select the risk/return profile that best suits their investment needs. Automatic 'Type B' treatment is likely to deter investment in CMBS by insurers, significantly reducing the options available to those that want CRE debt to have a place in their portfolios. In our view, this would not serve the interests of insurers or the insured public.

Furthermore, CRE is a socially and economically important and value-generating sector of the European economy.[1] It is capital intensive, and structurally reliant on a substantial amount of debt finance, as well as equity investment. In noting (at page 111) that SME loans are not the only channel of funding for the real economy, the Report might have also recognised the important contribution of CRE finance. Crucially, the characteristics of CRE debt mean that it is a naturally good fit within the capital allocation of insurers and other institutional investors. For that reason, unreasonable regulatory discouragement for investment in CMBS by insurers would be unfortunate, both for insurers and for the CRE sector and wider economy.

Finally, there is also an important financial stability dimension to this issue. The structure of the European CRE debt market as a whole is problematic, because it is very heavily dominated by banks, often lending on very similar terms. The result is a market that lacks resilience, as too many debt providers react to market signals in the same way at the same time, exaggerating the peaks and troughs of the cycle. This proved to be a source of material systemic risk within the EU and for the global economy. Improving diversity in sources of finance would help build market resilience and support financial stability.[2] EIOPA's revised proposal is likely to have precisely the opposite effect.

It is true that CMBS is a relatively new and small part of the CRE market in Europe, and the last few years have been particularly difficult. It has suffered from the problems identified on page 110 of the Report, namely inconsistent alignment of interests between originators and investors, and often poor investor information about the quality of underlying assets. But the industry is acutely aware of the need to address structural problems in the way European CMBS worked before the crisis. We are busy developing solutions and promoting improvements through industry dialogue, best practice

[1] The social and economic importance of CRE is explained in a paper jointly produced by two real estate industry bodies, EPRA and INREV, available here: http://www.epra.com/media/Real_estate_in_the_real_economy_-_EPRA_INREV_report_1353577808132.PDF.

[2] Promoting diversity and reducing excessive reliance on bank is a key element of the proposals of a UK real estate industry group seeking to improve CRE finance markets and their regulatory framework so that financial stability is better protected in future property market booms and busts. The initial output of that group is available here: https://www.ipf.org.uk/MainWebSite/Resources/Document/Real%20Estate%20Vision%202013.pdf.

guidelines and education and training.[3] Regulatory changes under the Capital Requirements Regulation (575/2013) designed to improve alignment of interests between originators and sponsors and investors should also assist.

Unfortunately, the proposals in the Report undermine the industry's efforts to address past problems and ensure that CMBS is a better product in the future, and make it harder for CRE debt originated by banks to be safely distributed to other financial institutions. Regulators should work together to reduce the concentration of CRE debt within the European banking system, improving its resilience. By classifying <u>all</u> CMBS <u>automatically</u> as 'Type B' securitisation, EIOPA will create an unnecessary and artificial obstacle that will make that more difficult.

There is nothing intrinsically wrong with CMBS as an instrument, any more than with other forms of securitisation. Neither is CMBS inherently riskier than other forms of CRE exposure. The risk in a bond is principally a function of the quality of the loans underpinning it. It follows that the senior tranche of a CMBS bond (the most widely attractive to insurance firms) will invariably be lower risk than the loans underpinning that bond. It is odd that the Solvency II capital regime ignores that fact, imposing higher risk weights on the bond than on direct loans. Rules that ignore economic reality will tend to distort capital allocation and investment decisions in potentially undesirable ways.

Conclusion

We are pleased that EIOPA has given such thoughtful consideration to how the capital treatment for insurers of securitisation (among other long term financial investments) might be improved.

However, regulatory capital treatment for a whole asset class that is indiscriminately penal for insurers – a core constituency of the investor base for CMBS bonds – risks reducing healthy diversification in insurer portfolios and causing irreversible damage to the CMBS market by placing it at a serious disadvantage relative to other comparable investments. The CMBS market is only gradually beginning to recover and reinvent itself post-crisis. EIOPA's revised proposals are likely to undermine the ability of a better CMBS market to support more diversified funding for CRE and a more resilient European banking sector. The supply of credit to the CRE industry, and thus the CRE industry's ability to serve occupiers and the economy at large, are also likely to suffer as a result.

We would welcome an opportunity to explore with you how the treatment of investments providing exposure to commercial property might be adjusted so as better to reflect economic risk, motivate product improvement, and address what are in many ways the shared interests of insurance firms and their customers, the real estate industry and financial stability.

Yours sincerely

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[3] For example, CREFC Europe's November 2012 document, *Market Principles for Issuing European CMBS 2.0*.

Appendix

CREFC Europe

The Commercial Real Estate Finance Council (**CREFC**) Europe is the voice of the commercial real estate (**CRE**) finance industry in Europe. It is our role to promote transparency and liquidity in CRE finance markets by developing and disseminating best practice and engaging with regulators, so our industry can flourish while playing its part in supporting the real estate sector and the wider economy. In addition, we act as the meeting place for the CRE finance industry, its constituent elements and its customer bases (those with capital to invest and those seeking finance), and provide education and networking opportunities for market participants. After the difficult years of the global financial crisis, we want to ensure that the industry we champion has a bright and sustainable future.

INREV

INREV is the European Association for Investors in Non-listed Real Estate Vehicles. Since its launch in 2003, it has grown to almost 350 members from more than 28 different countries. INREV's aim is to improve the accessibility of non-listed real estate funds for institutional investors by promoting greater transparency, professionalism and standards of best practice. INREV is led by institutional investors and supported by other market participants including fund managers, investment banks, academics, lawyers and other advisors. As a pan-European body, INREV represents a unique platform for sharing knowledge on the non-listed real estate funds market.