CREFC Europe

Achieving the potential benefits of CRE debt securitisation in Europe

Healthy and sustainable securitisation markets have an important role to play in the commercial real estate (**CRE**) debt market, as in other parts of the financial system. However, the rules European policymakers put in place after the global financial crisis (**GFC**) to encourage securitisation that is consistent with investor protection and macroprudential priorities have failed to deliver for the CRE debt market. As this paper explains, adjusting the existing framework could improve the resilience and diversity of CRE debt markets by encouraging more use of securitisation on a responsible and sustainable basis.

Background and context

CRE is a key part of the real economy. The CRE investment and development industry is a functionally essential, enabling part of the economy, providing quasi-financial services to ordinary businesses by allowing them to rent rather than build or buy the space they need. The ability to rent space flexibly (particularly with post Covid-19 demand for flexible accommodation and hybrid working) is especially important for dynamic, new and growing businesses with changing requirements. At the same time, CRE as an asset class offers attractive risk-adjusted returns to investors with a longer-term investment horizon, largely thanks to an illiquidity premium – to both equity and debt investors.

CRE debt is a key part of CRE. Acquiring, constructing and refurbishing buildings is capital intensive, so it is common for CRE investors and developers to borrow to help fund their activities. Combining equity (which has high return requirements to compensate for the risk it takes) with debt (which is less expensive because it takes less risk) reduces the cost of CRE as a key input for the economy. This is also an especially important consideration for maintaining a built environment that is fit for purpose: it is expensive to adapt buildings for socioeconomic, technological and climate change, especially as markets adjust after an extended period of artificially cheap money.

CRE debt and systemic risk. The GFC showed that there can be feedback loops between the CRE cycle and the credit cycle. Financial stability as well as economic growth can be threatened if lenders drive values up and over the peak, only to find themselves unable to provide credit after a crash because they are nursing large, distressed loan books that take years to resolve. However, poorly calibrated regulatory efforts simply to reduce the flow of credit to CRE lead to lower investment in the built environment, slowing the pace of decarbonisation and the upgrading that buildings need to improve productivity and meet occupiers' needs. Capital looks for other ways to access the risk and returns of CRE credit, outside regulators' field of vision.

A more strategic policy approach to CRE debt. A better approach was set out in the 2014 report, A Vision for Real Estate Finance in the UK. That report made seven high-level recommendations for how the CRE debt market should be structured and regulated, so that it provides a sustainable flow of credit to the CRE sector across the cycle without presenting unacceptable risks to financial stability. Despite its specific geographical focus and a decade of market evolution, the report remains highly relevant.

Changing CRE debt markets in the UK and EU. In the aftermath of the GFC, the UK regulator required the country's big banks to risk-weight their CRE lending exposures using "slotting" (rather than internal risk-based models). The result has been broad diversification of capital sources in the UK CRE debt market and reduced CRE risk in systemic UK banks.[1] EU regulators, by contrast, clamped down on securitisation without encouraging a diversification of debt supply away from banks. Many member states' insistence on banking licences to provide CRE loans is an extra hurdle for non-bank lenders. Today, CRE risk in many EU member states thus remains concentrated in the banking sector, with little transparency or secondary market liquidity. That is bad for market efficiency and effectiveness, as well as for financial stability.

[1] According to Bayes Business School research, at mid-2024, non-bank lenders accounted for around 43% of the total outstanding UK CRE loan book, compared to around 37% for UK banks and around 21% for international banks. Prior to 2012, UK banks routinely accounted for at least two-thirds of the market.

Climate change and CRE finance. A great deal of capital – much of it debt – will be needed to decarbonise the built environment and adapt it in response to climate change[2]. However, banks' regulatory incentives discourage the financing of transitional assets, and non-bank lenders are subject to their own constraints. A better-designed regulatory framework could allow securitisation to help, through a CRE-CLO[3] market (such as exists in the United States but not yet in Europe). CRE-CLOs could allow non-bank lenders financing brown-to-green strategies to recycle their capital, while giving investors attractive risk-adjusted returns with sustainability features – but only if regulatory barriers to CRE debt securitisation are lowered.

A brief history of European CMBS. Before the GFC, Europe was beginning to follow in the steps of the United States, developing a commercial mortgage-backed securities (**CMBS**) market that could allow non-originating investors to gain exposure to CRE debt in a more liquid form, with greater transparency, standardisation and diversification potential than other CRE debt products could offer. Crucially, European CMBS did not cause the GFC – but it was challenged by the GFC, for two reasons.

- First, CMBS was a nascent asset class that grew during a boom in the highly cyclical CRE market – and it suffered the consequences of the CRE market crash that followed. And yet, in a CRE lending market dominated by commercial banks, available evidence shows that pre-GFC securitised CRE loans performed significantly better than CRE debt of similar vintage originated by banks for their own balance sheets.[4] This is not surprising, given the protections built into the securitisation process and the weak supervision to which banks were subject at the time – but it is not widely appreciated.

- Secondly, the GFC was a stress test that revealed real weaknesses in the nascent CMBS market. The industry came together to address them, including through the development of CREFC Europe's Market Principles for Issuing European CMBS 2.0 (whose recommendations have generally been incorporated in post-GFC issuance). That effort needs to continue, to address more recently emerging problems, as well as to drive the growth of new products such as CRE-CLOs to support transitional CRE finance.

CMBS currently accounts for less than 5% of the European CRE debt market, and post-GFC issuance has remained at very modest levels. While non-bank capital seeking exposure to CRE debt has filled space left by retreating banks, this has happened mainly through the creation of new non-bank origination platforms, allocations to specialist fund managers and participation in the syndication market. That diversification of funding sources is welcome and adds resilience to the CRE debt market. However, it has not delivered the benefits of a well-functioning securitisation market: transferring risk out of the banks, providing rating agency scrutiny, offering a degree of secondary market liquidity in an inherently illiquid asset class, and bringing transparency and more standardised data to an otherwise private and opaque asset class.

Following the GFC, EU policymakers made decisions based on fundamental misconceptions about the performance of pre-GFC CMBS (see collated Bank of America research available here). Instead of supporting the industry's efforts to improve the product since the GFC, they ignored and so undermined them. It is time to focus on the potential benefits and adjust the regulatory landscape to achieve them.

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2 The Final Report of the EEFIG working group on *Applying the Energy Efficiency First principle in sustainable finance* (available for download here) cites a European Commission estimate of €180bn per year and Member State National Energy and Climate Plans contemplating €62.6bn of extra annual energy efficiency investments needed 2021-30.

3 CRE-CLOs are commercial real estate collateralised loan obligations – see for example, this Scope Ratings explainer.

4 2018 Bank of America research (see pp40-42 of this consolidated pack) cites Bank of England data to the effect that by 2018 UK banks had written off 10% of the pre-GFC CRE loan principal amounts they had originated to hold. That compares to principal write-offs of 4% of the £14.3bn of CRE loans of similar pre-GFC vintage originated and sold via conduit securitisation by UK banks. Across Europe, the equivalent figures for securitised CRE debt were aggregate losses of 3.7% of an original loan amount of €184bn (we have not seen data for European banks' retained CRE exposures but suspect they too are broadly in line with the UK figures).

Fixing the regulatory framework

The existing STS rules do not encourage well-structured CRE debt securitisation. Instead, Europe's post-GFC regulatory framework effectively excludes CRE debt from "simple, transparent and standardised" (**STS**) securitisation treatment entirely. This is unnecessary, because its small scale means this asset class does not present material risks to investors or financial stability. It is also damaging: a well-functioning CRE debt securitisation market could deliver real benefits to SME and other occupiers, to investors, by advancing decarbonisation, and from a macroprudential point of view.

The STS rules, including the additional criteria that unlock lighter regulatory capital treatment, should be modified so as to incentivise the CRE debt securitisation market to meet **appropriate** simplicity, transparency and standardisation criteria. The main areas that should be adjusted are the following.

- **STS eligibility: refinancing risk.**[5] Refinancing risk is a reality in the context of CMBS: the underlying CRE debt market is largely a bullet repayment market. However, post-GFC issuance mitigates this risk through a combination of lower attachment points, some principal amortisation and much longer tail periods between loan maturity and the legal final repayment date of the bonds. As a result, refinancing is much more likely to be possible, and it would be very unusual for the repayment of bondholders under a CMBS transaction to "depend predominantly on the sale of assets" – that would be the last resort. Yet Recital 29 and EBA guidance simply (and baselessly) assert the opposite. The rules and guidance should be conformed to the criteria-based approach under which a neutral interpretation would allow most post-GFC CMBS transactions to pass this test.

- **STS eligibility: homogeneity.**[6] The "simplicity" requirement for an STS securitisation to be backed by a pool of homogeneous underlying exposures unnecessarily excludes single loan CMBS transactions. The rule ignores the fact that, in the CRE context, the number of loans is not particularly significant, as credit and recourse depend on what is happening at the level of the tenants in the underlying real estate. Why should a transaction backed by a single loan secured on an apartment complex with hundreds of residential tenants fail this condition? Similarly, a transaction could be backed by one or two loans secured on buildings with a commercial use (as offices, shops or logistics facilities). These are all cases where the underwriting analysis required is of fundamentally homogeneous assets, which however do not fit the words in the rule. Indeed, investors may find it simpler to analyse such transactions than a CMBS transaction backed by a "pool of homogeneous underlying exposures" as contemplated by the rule. The homogeneity rule should be modified or disapplied entirely for CRE debt securitisation.

- **Capital treatment: concentration limits.**[7] A 2% maximum concentration limit for exposures to a single obligor is appropriate for asset classes where credit risk is on the obligor. However, it makes no sense in the CRE debt context, where obligors are special purpose entities designed to ensure that the structure is insolvency remote and provides adequate security. Rather than focus on the number of obligors, risk concentration measures should focus on the nature and quality of the underlying tenants who pay the rent that ultimately services payments on the notes. A CMBS transaction involving a single obligor with a loan secured on an apartment complex with 500 residential tenants should not fail the test. The pros and cons of one or multiple CRE borrowers (landlords), or indeed tenants, are complex and case-dependent. Cross-collateralisation, covenant strength and the correlation between the performance of different tenants or properties all need to be considered. The concentration limit should be modified (e.g. applied to tenants/credits, not obligors), or disapplied entirely, for CRE debt securitisation.

[5] See SECR Recital 29 and Article 20(13) criterion EBA guidance.

[6] See SECR Article 20(8) homogeneity criterion.

[7] See CRR Article 243(2)(a) condition.

- **Capital treatment: credit quality.**[8] The requirement that no commercial mortgage loan in the pool must have a risk weight higher than 50% under the Standardised Approach (**SA**) is problematic. The normal SA risk weight for CRE loans, which are typically non-recourse and to unrated borrowers, is 100% (the Basel III finalisation revisions replace that with new risk weights of 70%, 90% and 110%). While it is possible for 50% risk-weighted CRE loans to be securitised, that is an unnecessarily high bar, and the practical effect is to exclude CRE debt securitisation from reduced capital charges. The revised SA offers an opportunity for the rule to be rewritten to set a maximum risk weight of 70% or 90%.

- **Solvency II SCR for market risk and standard formula capital charges for non-STS securitisation exposures.** Research and analysis by Bank of America[9] confirms the intuitively obvious fact that, whether one focuses on market risk or credit risk, there is no possible justification for the penal capital charges that currently apply to even the highest rated CMBS exposures, compared to the much lower capital charges that apply for owning real estate directly, or holding unsecuritised CRE debt (whether rated high, low or not at all). The result has been to deny the CRE debt securitisation market access to a natural source of capital (life insurance companies), and to divert capital from that source to other forms of CRE debt exposure – which are *less* standardised and have *less* transparency and *less* secondary market liquidity than CMBS, yet attract much lower capital charges.

- **Liquidity treatment: lack of LCR eligibility.** Liquidity of investments and thus LCR eligibility is a key driver for bank investors. Unfortunately, another consequence of the poor design of the STS rules from the point of view of CRE debt is that CRE debt securitisation is effectively LCR ineligible, as eligibility currently turns on STS securitisation designation. In addition to modifying the STS rules to accommodate well-structured CRE debt securitisation, policymakers should consider expanding the LCR framework so that certain AAA-rated non-STS securitisations (which should include performing CRE debt securitisations) are also eligible as Level 2B assets.

Regulatory complexity and compliance costs are not justified by the benefits. Onerous and prescriptive requirements on investor due diligence and disclosure and template-based regulatory reporting add compliance cost for issuers and investors, raising the barrier to entry for new market participants rather than widening the issuer or investor base. This might be an acceptable price to pay if the result was high quality disclosures. Unfortunately, investors tell us that they do not find these regulatory disclosures useful, and rely instead on investor reporting by loan servicers. When regulators with little understanding of CRE debt chose to ignore existing, industry-developed investor reporting standards and imposed their own disclosure requirements, they condemned the industry to bearing the cost of regulatory disclosures without benefiting from the consistent reporting investors would like.[10]

Recent proposals for the regulatory definitions and requirements relating to "public" and "private" securitisation transactions to be reviewed are to be welcomed as one way of realigning disclosure obligations with the actual requirements of supervisors and investors. Further reforms aimed at destigmatising securitisation and reducing the regulatory burden to which it is subject (including a rethink about the approach to non-neutrality of capital requirements) would also be welcome.

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[8] See CRR Article 243(2)(b)(ii) condition.

[9] Included in the consolidated pack already referenced.

[10] A European version of the Investor Reporting Package developed and maintained by CREFC for the US market fell into disuse after European regulatory disclosures were introduced. As a result, the quality of disclosures for investors once again depends, as it did in the very early days of European CMBS, on what is produced by different third-party loan servicers. As of late 2024, the CREFC IRP in the US is on version 8.4.