

EIOPA (2022)0026630: Consultation paper on the advice on the review of the securitisation prudential framework in Solvency II

Q1: Do you have any comment on the comparison of the securitisation capital charges with other asset classes with similar characteristics?

We approach this question solely from the perspective of commercial real estate (CRE) debt securitisation and commercial mortgage-backed securities (collectively, CMBS), noting that, as elaborated in our response to Question 2, EU rules make it effectively impossible for exposures of this kind to qualify for STS treatment.

We do not think the comparisons that EIOPA has made are very illuminating, and can recommend alternative approaches, within the sector and asset classes that we know well, which could be much more informative.

The capital charges applicable under the standard formula for CMBS (as non-STS exposures), are penal, in the sense that they are so high, in both relative and absolute terms, that insurers using the standard formula are almost certain to prefer alternative ways of gaining exposure to the risk/return of CRE credit.

Insurers with internal models do however invest in CMBS on the basis of the capital charges determined by their model. For the many insurers rejecting CMBS because of penal standard formula capital charges, there are other options: allocating capital to specialist CRE debt fund managers (on either a segregated account, non-discretionary basis, or on a pooled, discretionary basis), buying exposures in the syndicated loan market, or indeed by setting up their own CRE loan origination platform. The capital charges applicable to such forms of CRE credit investment are, of course, different and lower than those applicable to CMBS under the standard formula.

As a result, CRE credit offers a natural experiment for EIOPA to explore the impact of capital charges.

First, EIOPA could collate information about the typical or average range for capital charges applicable to CMBS exposures under approved internal models, and compare those to the capital charges under the standard formula. That in itself would give an indication of whether the standard formula approaches CMBS in a reasonable way.

Secondly, EIOPA could breakdown the level of CMBS exposures held by insurers by reference to whether they are using internal models or the standard formula. This would show the attractiveness of CMBS in different capital charge conditions.

Thirdly, EIOPA could collate data regarding the level of investment by insurers in CRE credit in non-securitised form. This would give an indication of the appetite for CRE credit exposure that penal CMBS capital charges may be redirecting into products that are less transparent, tradeable or comparable.

Combining the above, EIOPA could produce a matrix comparing securitised and non-securitised CRE credit exposures across insurers, having regard to the capital charges applicable to each

(which will differ according to securitised status as well as according to whether the standard formula or an internal model is being used).

We suspect that the conclusions would show very clearly that the standard formula capital charges for CMBS have stifled such investment by insurers using the standard formula, whereas other forms of CRE credit investment (securitised by internal model users, and unsecuritised by all insurers) have flourished. It would also be possible to determine the durations preferred by insurers, and whether those vary according to the applicable capital framework.

In the meantime, there is clear evidence that issuance of CMBS in Europe has failed to recover to anything remotely resembling pre-GFC levels, or in the way that corresponding issuance has recovered in the United States, where the regulatory response to pre-GFC excesses was much more restrained than in Europe. As discussed further below, there is no evidence that securitised CRE debt poses greater risks to insurers (or indeed to financial stability) than unsecuritised forms of CRE debt (indeed, the opposite may be true).

EIOPA should conduct the detailed comparative analysis we suggest and, if the evidence supports doing so, recalibrate capital charges so as to remove the regulatory arbitrage they currently create.

Q2 Do you see practical or legal difficulties in investing in securitisation with the STS label? Are you aware of any other factors, including regulatory rules other than capital requirements that could have a major impact on securitisation investment levels?

Commercial real estate (CRE) debt securitisation and commercial mortgage-backed securities (collectively, CMBS) is effectively excluded from STS treatment. Recital (29) Securitisation Regulation prejudices against the natural interpretation of Article 20(13), which would incentivise good practice by differentiating between CMBS by reference to the nature and degree of dependence on the sale of assets. CMBS is also effectively excluded from STS capital treatment because of the requirement that no single exposure/obligor should represent more than 2% of the underlying pool – a rule that makes no sense for non-recourse CRE loans, where credit risk diversification should be tested, it at all, at the tenant level.

Why would any insurer using the standard formula invest in even AAA-rated five-year CMBS exposures (67% capital charge), given the much lower charges for comparable products (and even for direct real estate at 25%)?

The spread volatility in CMBS during the GFC does not justify this highly distortive regulatory framework. CMBS volatility was exaggerated during the GFC reference period by leveraged holding structures that are no longer in use; insurers are unlikely to require or expect CMBS holdings to have high liquidity; and the relatively high spread volatility of CMBS is a function of a small but public market - volatility is invisible, not lower, in the opaque and private CRE loan market to which penal capital charges drive insurers seeking CRE credit risk/returns.

The effective exclusion of securitised CRE debt from the benefits of STS treatment matters, because it can help finance (with lower risk/cost capital than investors' equity) the productivity-enhancing CRE industry, which provides quasi-financial services to SMEs and other businesses by providing and managing premises for rent, thereby allowing businesses to use capital and

other resources for their core business and not to build or buy premises from which to operate. CRE credit is also an important investable asset class alongside other, more liquid fixed income products.

Excessive exposure to CRE can be problematic for banks and financial stability, but non-bank investors have long found the risk/returns of CRE credit attractive, especially if, like life companies, they value an illiquidity premium more than high liquidity. The penal treatment of CMBS under Solvency II has led most insurers to gain CRE credit exposure through direct loans or allocations to debt funds. Direct lending maximises visibility and control, but with minimal secondary market liquidity, comparability or transparency. Allocations to debt funds effectively outsource the infrastructure required for a direct lending business, but still lack the enhanced secondary market liquidity, comparability and transparency offered by CMBS.

European CMBS emerged in the booming pre-GFC property market. Some notes performed poorly during the GFC, but where data is available (Bank of England / UK), it can be seen that securitised CRE debt suffered much lower write-offs than comparable unsecuritised debt. In any event, the CMBS industry tackled the problems revealed by the GFC (see “Market Principles for Issuing European CMBS 2.0” at <https://www.crefceurope.org/library/opendownload/250>), with better practice in post-crisis issuance, which has performed well with no principal losses to date.

Research shows that over 25 years, European CMBS volatility has been similar to that of REITs and broader corporates, and returns were less volatile than those of REIT bonds.

The high volatility exhibited by CMBS during the GFC was exaggerated by the fact that European CMBS exposures at that time were largely held by leveraged vehicles subject to margin calls. Market stress and value falls triggered margin calls which forced distressed sales and further value falls. Opportunistic investors who acquired CMBS at large discounts mostly saw substantial profits when prices recovered just a few months later. Those leveraged holding vehicles are no longer a feature of the European CMBS market, so the price volatility that one would expect to see in a period of comparable market stress should be lower. Life companies are unlikely to need to liquidate CMBS holdings in a crisis.

The fact that volatility is visible in CMBS markets should not be taken to imply that CMBS has higher spread volatility than comparable private, opaque CRE debt investments. The lack of a market in those other investments simply means their spread volatility is invisible – not that it is lower than CMBS volatility. It is wrong to punish CMBS with higher capital charges when it actually offers better secondary market access and pricing transparency, than secured loans (or, indeed, buildings).

Research cited is here: <https://www.crefceurope.org/library/opendownload/372>.

Q3 Do you have evidence that the current calculation for capital requirements for securitisation (senior STS, non-senior STS and Non-STS) is not proportionate or commensurate with their risk?

Our focus is solely on commercial real estate (CRE) debt securitisation and commercial mortgage-backed securities (collectively, CMBS). The capital charges for CMBS exposures (which

are, wrongly for a principles-based framework, effectively excluded from STS treatment) are neither proportionate nor commensurate with their risk.

This response references BofA Securities research (<https://www.crefceurope.org/library/opendownload/372>). After analysing the market price and total returns volatility of EUR, GBP and USD CMBS compared to relevant REIT and corporate bond indices, the research concludes:

"We find that the volatility of securitised notes has been similar to that of REITs and broader corporates over the past 25 years in Europe and the UK. The returns of securitised notes were less volatile, expressed as lower standard deviation, than REIT bonds but higher than corporates on average in both EUR and GBP denominations.

"Likewise, the UK securitised notes were less prone to fat tails, expressed as lower kurtosis, than corporate and REIT bonds. European securitised notes exhibited a particularly high kurtosis and negative skew owing to a negative 9-sigma return during the Covid pandemic. Previously, the kurtosis had been 0.0 for the 23 years since 1997.

"We think the pricing of the European securitised index may be less representative of the sector and could have been more sensitive to outliers owing to the small number (9) of constituents. By contrast, we think the results from UK securitised index may be more meaningful owing to the higher number (145) of constituents.

"Despite the limited pricing data in Europe, the EUR and GBP securitised indices had similar results to the bigger and deeper US CMBS index. This consistency lifts our confidence in the robustness of the European and UK securitised results.

"Volatility was higher during the Covid pandemic than the financial crisis in many cases including European corporate bonds, REITS and securitised bonds as well as UK corporate bonds. We think this illustrates the need to review regulatory frameworks in light of recent performance."

As to the spread volatility of CMBS during the GFC, it mainly reflects the fact that only this small part of the CRE debt market has any meaningful level of secondary market liquidity. Note the points made in our response to Question 2 about the (now historic) impact of leveraged holding vehicles, and about the fact that visible volatility in CMBS is almost certainly lower, not higher, than invisible volatility in the opaque and illiquid CRE loan market to which Solvency II instead pushes insurers using the standard formula. In the absence of data about the spread volatility of unsecuritised CRE loans, it is worth considering the volatility implied by the discounts at which European banks sold NPL portfolios (as much as 70, 80 or even 90%, we understand) in the years following the GFC.

Secondary trading is not common in the European CRE credit investment market – life companies are especially likely to hold to maturity, matching income to long-term liabilities and enjoying a yield premium over more liquid assets.

The research also assesses the credit performance of European CMBS over its 27-year history. As insurer investments in CMBS and CRE credit more generally are not in our view generally intended or expected to be highly liquid, credit risk may be a more useful metric for capital

charges for CRE debt (securitised and unsecuritised) than spread volatility. The research shows that the credit performance of European CMBS has been good.

Almost all CMBS losses arose in transactions issued in 2005-07, at the peak of CMBS's first property cycle, which ended with the GFC. For notes originally rated AAA, principal losses have amounted to just 0.3% of aggregate issuance. Total principal losses are just 2.2% of European CMBS since 1995. The industry has worked hard to improve CMBS since then (even in the absence of regulatory encouragement via the 'carrot' of STS capital treatment). There have been no principal losses for noteholders so far on post-GFC issuance.

There is no evidence that the securitisation of CRE debt increases market/spread or credit risk for investors, or even at the loan level. On the contrary, securitised CRE loans appear to perform better than loans retained on bank balance sheets.

As noted in the BofA Securities research, the 4% of principal losses arising on CRE loans originated and sold via conduit securitisation by UK banks between 2000 and 2008 compares favourably to the 9% write-offs cited by the Bank of England for non-securitised CRE loans. We have not seen such data from the ECB, but suspect European results would be similar. So credit performance would not justify penal capital charges for CMBS any more than spread volatility (if considered properly and fairly).

Q4 Do you agree with the calibration method used in this paper? Do you have any evidence that an alternative method could have been used?

No. See responses to other questions.

Q5 Do you agree with the conclusions obtained in this section? Do you have any evidence which suggests that the conclusions could be different?

No. See responses to other questions.

Q6 What is your view on the proposed segmentation of the STS category: should the calibration of the Non-Senior STS Securitisation be differentiated between mezzanine and junior? (Option 1 or 2 of page 31). Please explain your view. If Option 2 is your preference, do you think it would encourage you to invest more into securitisation with the STS label?

Option 2.

The starting point is that the Solvency II capital framework currently allows effectively no differentiation at all within the CRE debt securitisation asset class.

EIOPA's goal should be to reduce the current, unjustified (in terms of the evidence, properly investigated and assessed) regulatory arbitrage in favour of non-securitised CRE credit investments, and create a regulatory incentive for well-structured transactions.

To that end, adjustments should be made to allow differentiation through improved calibration of STS criteria so that well-structured CRE debt securitisation transactions can qualify for STS treatment.

In addition (but especially if the STS criteria are not adjusted in that way), the capital charges for non-STS CRE credit exposures should be reduced to levels that are more broadly in line with those applicable to comparable CRE credit exposures (and to a level that is not, as the current levels are, inexplicably much higher than the capital charge for direct real estate investments).

It is perverse that the very illiquidity of private loans and buildings, which results in their prices appearing less volatile in stressed conditions, should mean that they attract lower capital charges than public securities whose relative liquidity allows volatility to be seen in a time of stress.

As a relatively minor point beside those important points, recognising the difference between different risk tranches would be better than not doing so.

Q7 What is your view on the preliminary conclusion not to implement the underlying exposure risk as a basis for the securitisation risk charges in Solvency II? Do you have any evidence which suggests that this conclusion could be different?

Please see our responses to other questions. As a general matter, for CRE credit exposures, there is no evidence to suggest that securitised investments are either more volatile or present greater credit risk compared to comparable unsecuritised investments - indeed, it seems more likely that the opposite is the case.

It is possible that the analysis set out in section 3.2.2 of the consultation paper has some basis in evidence and truth for other asset classes, but it is simply not supported by any evidence in relation to CRE debt and CMBS. Again, see the BofA Securities research (<https://www.crefceurope.org/library/opendownload/372>).

Therefore, and as argued in our responses to other questions, reducing or eliminating the substantial (and penal) capital surcharges applicable to CMBS and other CRE debt securitisation investments so as to bring them more closely into line with the underlying exposure risk would be appropriate.

Q8 What is your view on the preliminary conclusion not to implement the considerations for the thickness of non-senior tranches in Solvency II? Do you have any evidence which suggests that the conclusions could be different?

We express no opinion in relation to this question.

Q9 What is your view on the proposed segmentation of the non STS category: should the calibration of the non STS securitisation be differentiated between senior and non-senior? (Option 3 or option 4 of page 36)? Please explain your view. If Option 4 is your preference, do you think it would encourage you to invest more into Non-STS securitisation? (Section 3 - page 43)

Option 4.

We have no opinion as the options under consideration appear to have no relevance to the asset class about which we are knowledgeable. The question refers to the "non STS category" and "non STS securitisation", but the options in the consultation paper actually refer to "the STS category" and "non-senior STS category" – so we assume the wording of the question is wrong.

We have selected an option solely because your survey form forces us to do so, not because we support that option. Our response should not be included in any count of responder preferences as between the options.

Q10 What is your view on the preliminary conclusion not to implement the hierarchy of approaches in Solvency II? Do you have any evidence which suggests that this conclusion could be different?

We express no opinion in relation to this question.

Q11 Do you consider that agency and modelling risks are reflected in an appropriate manner in Solvency II? If the answer is “No”, please elaborate on the changes that you deem necessary.

We believe that these risks are immaterial in the context of the asset class about which we are knowledgeable (CRE debt securitisation, including CMBS).

Model risk is irrelevant in an asset class where the number of underlying exposures is typically very small and investors, analysts and rating agents routinely analyse each individual underlying exposure rather than relying on financial models and statistical analysis (and are provided with sufficiently detailed information to allow them to do that).

See our response to Question 3 (and the underlying research referenced there) for evidence that securitised CRE loans performed better during the GFC than similar loans that were not securitised.

The risks identified by EIOPA are no doubt theoretically relevant, but there is no evidence that they actually affect the CRE debt securitisation market (in the case of model risk, unsurprisingly given the way EU regulation has prevented the market from achieving any scale). We would be very happy to organise a teach-in if officials would like to gain a better understanding of CRE credit and/or CRE debt securitisation.

Q12 What is your view on the preliminary conclusion not to use the maturity (as in CRR) for the Solvency II framework?

For asset classes (like securitised CRE debt, including CMBS) that are not intended or expected to offer high liquidity, the maturity approach does not seem to us to make much sense. As explained elsewhere in these submissions, investors in CMBS typically buy to hold to maturity. They select this asset class in part because of the illiquidity premium that it offers - that being worth more than higher liquidity, especially for investors such as life companies seeking to match long-term income to long-term liabilities.

The fact that longer duration securitisation exposures are subject to very high capital charges is the most obvious explanation for the very short duration of securitisation holdings that EIOPA observes among insurers. The capital framework skews against the longer durations that life companies might naturally prefer. The research we recommend in our response to Question 1 would no doubt offer additional insights and evidence to support decisions in this area.

We cannot comment on what is appropriate for other asset classes, but for CRE debt securitisation and CMBS, a focus on credit risk would seem to be a smarter and more appropriate than the focus on spread volatility and maturity.

Q13 Do you consider that other technical amendments may be appropriate or desirable to improve that treatment of securitisation in Solvency II? If the answer is “Yes”, please elaborate on the changes that you deem necessary.

We approach this question solely from the perspective of commercial real estate (CRE) debt securitisation and commercial mortgage-backed securities (CMBS).

The consultation paper recognises the very modest levels of securitisation investment across insurance firms. As explained in our response to Question 1, it would be possible to collate and analyse data comparing internal model and standard formula users, and investments in securitised and unsecuritised CRE debt, to assess the degree to which regulators have artificially created that situation through capital calibrations under the standard formula. We would encourage EIOPA to do that research before concluding (contrary to anecdotal evidence and contrary to our intuition as a specialist industry body for the CRE finance market) that the capital calibrations are appropriate.

We would emphasise that the definition of securitisation set out in section 1.2 of the consultation paper does not fully recognise the role that securitisation can play in the context of CRE debt. Securitisation is not merely a tool for banks to recycle their capital in this market. It can also operate as an additional channel for real estate firms to access credit from the capital markets directly (through the agency of investment banks). There is also untapped potential for non-bank CRE lenders to access the capital markets through the use of CRE CLOs. Unjustifiably penal standard formula capital charges for CRE debt securitisation arbitrarily restrict the appetite of insurers for all of these products. They thus adversely affect the potential of securitisation to support a diverse CRE financing market with a degree of transparency, standardisation and secondary market liquidity missing from other CRE credit products.

There are enormous, socioeconomically important challenges ahead for the real estate sector, in terms of decarbonisation, as well as to ensure that the built environment remains fit for purpose in the face of changing technology and social norms for how we live, work and spend our leisure time. The long-term capital that insurers can deploy could play a vital, productive role in delivering the requisite investment (both as higher risk/return equity invested directly in buildings, and as lower risk/return credit, in securitised as well as unsecuritised form).

There is no evidential basis whatsoever to justify regulatory barriers that steer insurers' CRE credit investments solely into unsecuritised, rather than (at least to some degree also) securitised, products.

As mentioned above, the spread volatility in CMBS during the GFC does not justify the current, highly distortive regulatory framework. CMBS volatility was exaggerated during the GFC reference period by leveraged holding structures that are no longer in use. Insurers are unlikely to require or expect CMBS holdings to have high liquidity (valuing, instead, the illiquidity premium, as well as the degree of transparency, standardisation, comparability and secondary market liquidity they offer as compared to other CRE credit products). And the relatively high spread volatility of CMBS is a function of a small but public market - volatility in the opaque and private CRE loan market to which penal capital charges drive insurers seeking CRE credit risk/returns is hidden, rather than lower.

There are two solutions that should be considered to correct the current regulatory framework as it affects CRE debt:

- (a) The STS criteria should be re-formulated and/or interpreted in such a way as to encourage well-structured CRE debt securitisations, by rewarding well-structured transactions with STS capital treatment. Simply excluding an entire product category and asset class is poor regulation, and creates regulatory arbitrage risk.
- (b) The capital charges applicable to CRE debt securitisation under the standard formula need to be reduced so that insurers using the standard formula are not effectively forced to get their CRE credit risk/return in unsecuritised form. We have referenced research and analysis that shows that neither spread volatility nor credit risk can justify a strong regulatory preference for unsecuritised exposures. EIOPA has not presented any contrary data. Insurers should be offered something closer to a level regulatory playing field, so that they can choose the form of CRE credit exposure that best suits their requirements.