

Response to CP16/22 (Implementation of the Basel 3.1 standards)

The Commercial Real Estate Finance Council (**CREFC**) Europe is the industry association representing real estate debt providers and the wider real estate finance market in the UK and Europe. We promote well-functioning, responsible and sustainable markets that are appropriately transparent and liquid. We believe that these markets should serve lenders and those investing their own or others’ capital as well as real estate businesses seeking credit, without presenting unacceptable risks to financial stability.

We are grateful for the opportunity to comment on these proposals for the implementation of Basel 3.1 standards in the UK. We have responded from the narrow, specific perspective of the market that is our specialist subject: the commercial mortgage market, in which UK banks play an important role.

Background

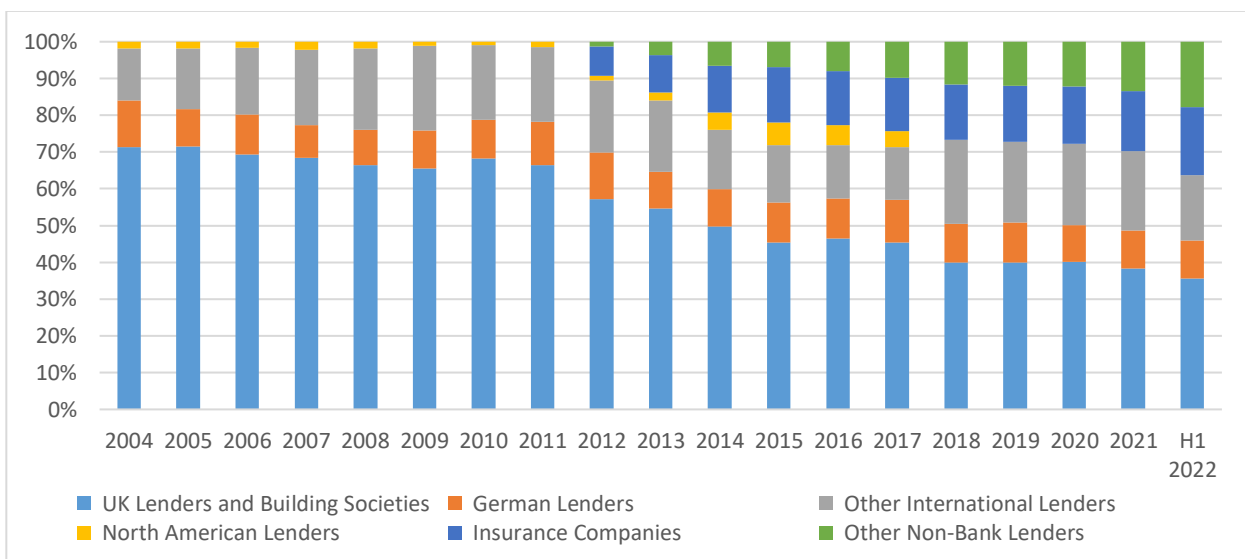
Commercial real estate (**CRE**) has always been a natural user of credit. Combining debt with equity capital suits the needs of this highly capital-intensive sector of the real economy. Looking ahead, capital is needed not merely for construction projects, property acquisitions and routine refurbishments, but also for the large-scale decarbonisation necessitated by climate change, and the repurposing of assets required by the way the GFC and the pandemic altered the way we live, work and shop.

It should also be remembered that rental housing development (build-to-rent or **BTR**), while a relatively new feature of the UK residential property market and starting from a low base, is an increasingly important component of new housing supply. Despite its residential use, BTR is part of the CRE universe, alongside other specialist sectors like purpose-built student accommodation (**PBSA**) and senior living.

CRE is also intrinsically attractive to lenders, as a real asset that is income-producing, over which security can be taken. The fact that it can be underwritten independently of a borrower’s broader business (where the performance of a loan is materially dependent on cash flows generated by the property) can be an attractive feature. As a relatively opaque, private market, real estate debt offers an illiquidity premium compared to more liquid fixed income products perceived as presenting similar credit risk.

The UK CRE finance market has become increasingly diversely sourced since the GFC. According to the most comprehensive data available, non-bank lenders now account for around 35% of the market – a similar level to UK banks and building societies, with the balance provided by international banks.

Share of the UK CRE loan book by lender type (Bayes Business School CRE Lending Report, H1 2022)



Post-GFC changes to the regulatory framework for UK banks (notably, the imposition of Slotting for income-producing real estate (**IPRE**) exposures) played a decisive role in shaping this diverse landscape.

Different sources of credit serving the CRE market are subject to very different prudential regulatory frameworks:

- Slotting for large UK banks
- A-IRB or F-IRB for international banks
- The Standardised Approach (**SA**) for challenger and other banks
- Approved internal models or the standard formula under UK or EU Solvency II rules, or other international prudential frameworks, for different insurance firms (which may access this market through real estate loans made directly or by debt funds to which they have allocated capital, or through the securitised or ordinary corporate bond market, each attracting different treatment under those frameworks)
- AIFMD or other funds regulation, not involving risk-based prudential regulatory capital regulation, for debt funds
- No regulatory framework at all (for example for certain family offices or other private lenders).

Such diversity means that capital with different strategies (return requirements and risk appetites, time horizons, sector or geographical preferences, etc.) can coexist and compete in the same market. Different lenders are likely to respond in different ways to market events and signals, adding competition and resilience to capital supply. As a result, the diversity of the UK's CRE financing market should be celebrated and protected. Crucially, though, banks provide the underpinning, providing a large volume of low cost credit. Even relatively small marginal changes to that supply can have significant impacts across the wider market.

A Vision for Real Estate Finance in the UK

An independent real estate industry report prepared with the encouragement of the Bank of England and published in May 2014 (the **Vision report**)¹ took an informed, holistic and strategic look at the UK's real estate finance market in the aftermath of the GFC and made seven high-level recommendations (reproduced at **Appendix 1**) to assist policymakers in regulating it in such a way that it might perform its economic function effectively without presenting unacceptable risks to financial stability.

Recommendation 6 urged UK regulators to foster the kind of diversity of supply that could improve financial system resilience and stability. We are fortunate that, in contrast to most EU markets, the UK has achieved that.

It is worth noting three other recommendations made by the *Vision* report.

Recommendation 1 highlighted the importance of comprehensive market data, without which regulators cannot hope to regulate effectively. This recommendation has only grown in importance as the role of credit provided by lenders outside the PRA's regulatory perimeter has grown into a more material component of the overall real estate finance market (as illustrated in the chart above).

¹ A Vision for Real Estate Finance in the UK (the *Vision* report), available here: https://hubble-live-assets.s3.amazonaws.com/crefc/file_asset/file/288/Vision_Report.pdf.

It is striking that (by reference to UK bank assets generally, rather than specifically in relation to real estate exposures), CP16/22 appears to acknowledge that UK regulators do not know to what degree changes in the level of average RWAs in UK banks are a result of changing underlying risk level or changing assessment of risk.² The CP concludes that *“This highlights the importance of ensuring risk measurement remains robust to underpin confidence in capital ratios and the quantum of capital set against risks.”* We would argue that it also highlights the need for better market information, because resorting to a precautionary “better safe than sorry” approach is not cost-free. Returning to real estate, it is disappointing that, nine years after the *Vision* report was published, regulators and the market still lack comprehensive, granular, timely and interrogable real estate credit market data.

Recommendation 4 advocated developing long-term value metrics for real estate collateral, to help lenders and their regulators understand market value-based LTV against the context of the property cycle. That in turn could allow better risk differentiation in regulatory capital rules (**Recommendation 5**). That is essentially what the revised SA and the “prudently conservative” approach to valuation set out in the 2017 Basel 3 framework aim to do.

Considerable work by the industry and academia in the years since the *Vision* report was published has clearly shown that (a) this can be done, but (b) it should be done using market- or sector-level modelling and analysis and applying an adjustment to asset level market values, not by changing the way individual real estate assets are valued. We have set out a relatively detailed but practical outline of how such a model can be used to achieve the counter-cyclical protections that are proposed for regulatory commercial real estate at **Appendix 2**.

Headline feedback

It is important to balance the protection of financial stability with the need for credit to reach the real estate market. Banks have long ceased to be the only lenders to real estate (and that is a good thing), but they remain a major source of low-cost credit. If the contribution of UK banks is further constrained by regulatory interventions, that is likely to lead to a combination of reduced credit availability and more expensive credit.

As that would affect the financial viability of capital expenditure, it would have implications for the quality of our built environment (impacting both communities and business productivity); and for the UK’s capacity to meet the climate change challenge (in particular, net zero goals through the decarbonisation of buildings that are responsible for a quarter of the UK’s GHG emissions). Accordingly, efforts to manage risk need to be undertaken with care, having regard to broader policy objectives and recognising likely trade-offs and anticipating likely unintended consequences.

In terms of the specific proposals as they affect the commercial mortgage market:

- **SA risk weights and valuation approach** need to be mutually coherent. Risk weights should be flexed down as well as up by reference to LTV ranges as recommended by the BCBS (and shown by industry research³ to make sense), the disruption and friction that would result from the imposition of a new “prudently conservative” approach to property valuation would not in our view be justifiable.

If the PRA follows the risk weights proposed by the BCBS (in particular for ‘regulatory commercial real estate’ that is materially dependent on cash flows generated by the property), a prudent

² See para 1.15: *“Average risk weights fell from 37% in 2015, at the time of the negotiations of the Basel 3.1 standards, to historically low levels of 25% in 2020. That trend could reflect a number of factors, including firms shifting to less risky assets and historically low levels of losses, but it could also reflect, in part, under-estimation of internally modelled risks due for example to model risk and data uncertainties.”*

³ The research is referenced in footnote 6 and further cited in **Appendix 2**.

valuation approach can work, as illustrated at **Appendix 2**, and would have our support – **provided** a market- or sector-level analysis is used to adjust asset-level market value. We would not recommend tinkering with asset-level valuation.

- **Capital expenditure on buildings** has an incredibly important role to play over the coming years, both for the perennial challenge of housing delivery, and to help ensure that our built environment remains fit for the purposes of a changing society and economy, as well as because of the urgent and daunting demands of decarbonisation. Buildings that do **not** undergo necessary repurposing or decarbonisation retrofit may go surprisingly rapidly from prime income-producing assets to economically unviable.

The emerging residential build-to-rent sector (where rental housing is developed for long-term institutional ownership and professional management) should not be treated in the same way as speculative construction finance for risk weighting purposes, simply because it is not susceptible to pre-sale or pre-lets.

More broadly, a risk weighting framework that automatically treats construction, development, refurbishment and repurposing projects as riskier than the financing of income-producing assets may misunderstand the way climate change and structural change in the built environment are requiring buildings to adapt. Indeed, such a framework could end up laying the foundations for the next real estate-related banking crisis, as well as failure to meet the UK's net zero carbon commitments.

These concerns are relevant both to the 150% SA risk weighting category for land acquisition, development and construction exposures, and to the proposed introduction of a new HVCRE Slotting category. We would welcome an approach that carved out certain socioeconomically important and fundamentally lower risk activities from ADC or HVCRE treatment (see for example the way US regulators exempt community development, projects at sensible leverage levels with a minimum equity investment by the borrower, from their HVCRE framework).

- We generally welcome the changes to the **preferential risk weights available under Slotting for IPRE** (both in adding conditions for short maturity exposures, and for allowing a “stronger” slot in some circumstances regardless of maturity). However, the conditions for the “stronger” slot are too tightly framed and should be reconsidered.

We set out below our more detailed responses to selected questions from the consultation paper.

Please contact Peter Cosmetatos, CEO, CREFC Europe, at pcosmetatos@crefceurope.org or on 07931 588451 to discuss any of our submissions further.

Responses to selected questions

All our responses are given from the point of view of regulatory commercial real estate that is materially dependent on cash flows generated by the property, as that is the market with which we are familiar.

Chapter 3 – Credit risk – standardised approach

Q13: Do you have any comments on the PRA’s proposal that the value of the property shall be measured at origination and on the proposed approach to determining origination value? Do you have any comments on the proposed prudent valuation criteria?

Value at origination

It is entirely appropriate and natural that the initial value of the property should be the value at origination, and we strongly support the use of prudent valuation criteria specifically at origination – that is when such criteria can operate counter-cyclically.

More broadly, we are unsure whether annual revaluation (which is common in the market for other purposes (e.g testing LTV covenants, IFRS9), and helps ensure that a lender has a relatively up-to-date understanding of the value of the collateral it holds) should be effectively discouraged by the regulatory capital framework.

We would also warn against the assumption that the preferred macroprudential approach is for valuations always to err on the side of undervaluation (as the PRA’s proposals seem intended to ensure). An approach that is sensitive to the property cycle and aims to operate in a truly counter-cyclical way would not only mitigate excessive leverage towards the peak of the cycle, but also avoid discouraging lending after a significant correction, when it is most economically valuable and least risky.

Proposed approach to determining origination value: prudent valuation criteria

In principle, we would support a more property cycle-sensitive approach to property valuation – indeed, that was recommended by the [Vision report](#), as the basis for counter-cyclical and risk-sensitive regulatory capital rules. Considerable industry and academic work has been carried out over the last decade to determine how that objective might best be achieved, from which some clear conclusions can be drawn.⁴ In essence, those conclusions are that:

- It would be virtually impossible to develop prudent valuation methods at the individual property level because of both data and skills deficits; but
- A consistent prudent value regime would be deliverable on the basis that market value-based individual property valuations would be adjusted using a market- or sector-level analysis of the property cycle.

The criteria for prudent valuation set out in CP16/22 are not detailed, and would seem susceptible to being achieved using a market- or sector-level market analysis-based adjustment approach, rather than

⁴ The first relevant report, *Long-term Value Methodologies and Real Estate Lending*, published by an industry working group in 2017, is available here: https://hubble-live-assets.s3.amazonaws.com/crefc/file_asset/file/289/Vision_R4_long_term_value_methodologies_report_June_2017.pdf. Detailed academic research, published in 2020, is available here: <https://www.ipf.org.uk/resourceLibrary/ipf-long-term-value-methodologies-in-commercial-real-estate-lending--july-2020--full-report-.html>. The most recent research was published this month: <https://www.ipf.org.uk/resourceLibrary/the-implementation-of-long-term-prudent-valuation-models-across-the-uk-and-mainland-europe-for-financial-regulation-purposes--march-2023--report.html>.

by attempting to replace property-level market valuation with something different. We could support such an approach, in the right context.

The logic behind the proposed move from traditional market value to prudent or prudently conservative valuation criteria is stated to be “*the proposed key role of LTV to calculate the SA risk weight for real estate exposures*” (para 3.159). However, whereas the 2017 Basel 3 framework does indeed give LTV a key role (with three different risk weights of 70%, 90% and 110% applicable to different LTV ranges), the PRA’s proposed implementation of Basel 3 does not. The PRA proposes the retention of the 100% risk weight, modified only with the addition of a slightly higher, 110%, risk weight where the LTV is greater than 80%.

We believe that the use of a cycle-sensitive adjustment to market value (based on a market analysis model, not a replacement of market valuation at the asset level) would be entirely appropriate alongside a move to the risk weighting framework set out in the Basel 3 framework. We do not consider that imposing a change to valuation methodology is desirable or justifiable with the very modest change the PRA proposes to the old SA risk weights.

We discuss the proposed approach to risk-weighting in more detail in our response to Q14 below and in **Appendix 2**, where we set out a worked example of how a more counter-cyclical framework could operate.

Q14: Do you have any comments on the PRA’s proposed approach to risk-weighting real estate exposures?

Generally (main risk weights)

We believe the proposed risk weightings set out in para 3.176 are (a) too high, (b) insufficiently risk-sensitive, and (c) incorrectly calibrated (especially having regard to the risk weights applicable under Slotting). We discuss each of these concerns in turn. We then also comment on the proposals in paras 3.184-3.187 relating to land acquisition, development, and construction exposures (**ADC**).

Too high

We would like to understand the evidence that leads to PRA to conclude that the SA risk weight for regulatory commercial real estate should be “no lower than 100%”, notwithstanding (a) the BCBS recommendation for three different SA risk weights of which two are below 100%, and (b) the PRA’s proposed expansion (which we support) of the preferential 50% Strong risk weight under the Slotting framework for IPRE. We believe there is both evidence of low credit risk at low LTV levels, and strong logical grounds for regulatory capital rules to incentivise low LTV lending.

In the absence of strong grounds for maintaining such a high minimum SA risk weighting, we would be concerned that the consequences would be a combination of (a) less credit, or (b) more expensive credit, for capital expenditure on or transactions in commercial real estate. It is especially the case today and over the coming years that a great deal of investment in commercial buildings is required:

- to ensure that our towns and cities adapt to remain fit for purpose as the ways society and the economy use buildings change (we have seen Retail and Industrial/Logistics property transformed through the internet, the GFC and the pandemic, and the pandemic has also changed the Office),
- to decarbonise our built environment and make it fit for a low carbon future (according to the British Property Federation⁵, 80% of the UK’s 2050 building stock is already standing, and we need to

⁵ The BPF’s February 2023 report *Towards Net Zero* is available here: https://bpf.org.uk/media/5945/towards_net_zero.pdf.

increase the rate at which we're upgrading it by at least 5% annually to meet global carbon emissions standards by 2050), and

- to support communities and business productivity generally.

Having pulled back significantly from real estate lending over the last 10-15 years, banks will surely have a significant role to play in helping to finance that investment. We would encourage the PRA to adjust its approach so as not to disincentivise SA banks from making their contribution to funding the capital expenditure required for a modern, low carbon, built environment. We have seen no evidence to justify a minimum SA risk weight of 100%, whereas there is plenty of evidence that low leverage CRE lending can present very low levels of credit risk.

Insufficiently risk-sensitive

We are well aware of the problems with relying solely on market value-based LTV as a lending risk metric – they were discussed in detail in the 2014 [Vision report](#) and 2017 [follow-on work](#) which also proposed pragmatic and effective solutions. However, very clear differences in risk level can be seen between different LTV levels. Bank of America carried out detailed research (most recently updated in March 2023)⁶ into the performance of securitised pre-GFC real estate loans, and concluded that there is a tipping point in terms of default risk at around 60% LTV (which accords with the intuition of people familiar with CRE). The 2017 Basel 3 framework also recommended a risk weighting boundary at that level (70% up to 60% LTV, 90% above).

We urge the PRA to follow both the BCBS and the Bank of America research mentioned above and cited in footnote 6 below, and add risk sensitivity under the SA around the 60% LTV threshold, so as to incentivise lending at lower credit risk levels.

Incorrectly calibrated

For those banks willing to lend at higher LTVs than 80%, the additional risk weight is a surprisingly modest increase from 100% to just 110%. Compare that difference not only to the broad range from 70% (up to 60% LTV) to 90% (greater than 60% and up to 80% LTV) to 110% (greater than 80% LTV) SA risk weights proposed by the BCBS, but also to the even broader range from 50% (preferential Strong) to 70% (non-preferential Strong and preferential Good) to 90% (non-preferential Good) to 115% (Satisfactory) to 250% (Weak) for non-defaulted IPRE exposures under Slotting.

We believe it would be a mistake for the UK to diverge from Basel 3 in order to impose so little risk weighting differentiation, and only at such a high LTV level, under the revised SA. We should not have to depend on Pillar 2A add-ons or other special adjustments to restore sanity. Simply following BCBS recommendations would broadly align the risk weight range of SA banks (70% to 110%) that the main range under Slotting (70% to 115%, if one ignores the preferential Strong and Weak slots).

The proposed calibration would surely make it difficult for UK regulated SA banks to compete for sub-60% LTV (a proxy for low risk) CRE lending, while inviting them to compete for high LTV (and high risk) CRE lending. This is a fundamental weakness of risk weighting frameworks that lack adequate risk sensitivity, as we saw in the years before the GFC, when some banks responded to a flat 100% risk weighting for CRE by taking on more and more risk as the market overheated, with regulators looking on.

⁶ The Bank of America research *Which European CRE loans defaulted and why?* (March 2023 update) can be accessed here: https://hubble-live-assets.s3.amazonaws.com/crefc/file_asset/file/792/BofA_research_-_which_European_CRE_loans_defaulted_and_why_March_2023_update.pdf.

We urge the PRA to reconsider this calibration, to enhance the incentives for low LTV, low risk CRE lending, and to increase the disincentives for very high LTV, high risk CRE lending.

ADC exposures

As noted above, it is true that loans that entail exposure to planning or construction risk are in general likely to present higher credit risk than loans against stabilised, income-producing property, or against construction projects that have been substantially pre-let or presold (in which case the source of repayment at origination of the exposure would not be relevantly “uncertain”).

But while use of higher risk weights for ADC exposures than for most non-ADC exposures would not appear unreasonable in principle, we do not think it justifiable to treat all ADC exposures as requiring a higher risk weight than all non-ADC exposures (though we appreciate that avoiding that outcome might involve diverging from the Basel 3 framework, and we are reluctant to recommend that). There are two particularly important areas where the proposed approach would benefit from fine-tuning.

Build-to-rent residential (BTR)

One element of the solution to the UK’s housing supply challenges is the small but rapidly growing institutionally owned and professionally managed residential rental sector. The current challenges around mortgage affordability add to the socioeconomic importance of the role BTR can play.

The lack of existing suitable stock combined with the structural shortage in the supply of new homes means that this sector typically requires the construction of apartment blocks or complexes specifically for rental. The scale of many of these schemes and the need to design for efficient operation for decades drive innovation both technologically through offsite precision manufacturing (modular construction) and through environmental, social and governance (ESG) features.

Unlike traditional build-for-sale residential (which can be sold off-plan) and traditional commercial development (which can be wholly or substantially pre-let), BTR schemes can only be stabilised through a letting-up process starting when construction is more-or-less complete. It would be a mistake, however, for risk weighting rules to treat BTR schemes in the same way as speculative non-BTR developments.

The structural housing supply/demand imbalance is so pronounced that competent BTR developers and operators can have a high confidence level that their scheme will let. With suitable protections against cost overruns and delays (which sufficient equity can address), the main risk is that targeted rents cannot be achieved – and lenders can underwrite on more cautious rental assumptions to protect against that. The fundamental risk that a speculative commercial development stands empty for years does not really apply in relation to BTR.

The notion that a 95% LTV loan against a poor quality but income-producing commercial building should carry a materially lower risk weighting (at 110%) than a high quality BTR development financing (at 150%) – unless special adjustments are used to restore sanity – strikes us as a very odd way to set up the risk weighting framework.

We would recommend an additional carve-out from the 150% risk weight in the case of build-to-rent residential real estate so that bank finance can continue to support the growing and socioeconomically important institutional BTR market.

Funding capital expenditure and decarbonisation

CRE investment and finance were traditionally about assets changing hands (or, to a much more limited degree, being constructed). However, the coming years seem set to be characterised by a far higher focus on the assets themselves and their actual users. The three most powerful drivers behind that are (i) changes in how we shop and use offices (revealed and accelerated first by the GFC and then by the pandemic), (ii) changing occupier preferences (shorter leases and a growing appreciation of flexibility), and (iii) climate change and the need to decarbonise (with real estate a major contributor of emissions and a major potential source of emissions reductions).

Unlike housing and the BTR point made above, which relates mainly to new construction, this is primarily about renovation, refurbishment and repurposing (i.e. changing the use designation) of buildings. It is not clear to us to what degree it might be impacted by the ADC risk weight (the potential impact seems more significant in the context of HVCRE, discussed below). If there is any doubt, we would urge the PRA to clarify that financing this kind of expenditure on existing buildings does not generally fall within the 150% risk-weighted ADC category.

Chapter 4 – Credit risk – internal ratings based approach

Q22: Do you have any comments on the PRA’s proposal to remove the SME support factor under the IRB approach? Do you have evidence – quantitative or qualitative – regarding the appropriateness of the IRB approach for SME exposures in the absence of the support factor?

This question strays outside our area of expertise, but we have one comment, in the light of the important relationship between CRE and the SME economy (including in the context of bank lending) and market feedback we have received.

For smaller SME CRE lending, there is currently a capital requirement reduction from the SME Support Factor. The PRA proposes to withdraw this, but the evidence it cites is a 2016 EBA study which was in fact inconclusive and recommended further work. Since then, we understand that further work has indeed been conducted in three separate studies by the German, French and Spanish central banks, which the PRA has not referenced. We understand that all of those studies unambiguously conclude that the SME Support Factor encourages SME lending and results in appropriate capital requirements given the much higher diversification of SME lending (compared to the systematic correlation seen in corporate lending). Is the PRA able to point to empirical evidence from the UK that justifies its conclusions, or might this be an area that would benefit from further thought?

Q32: Do you have any comments on the PRA’s proposals for specialised lending?

We comment on three aspects of the proposals: (i) the introduction of a new HVCRE Slotting category, (ii) the conditions around the preferential slotting risk weight where the remaining maturity of the exposure is less than 2.5 years, and (iii) the extension of the preferential slotting risk weight to exposures (of whatever remaining maturity) with “substantially stronger” features than the criteria specified for the strong category.

HVCRE

As explained in our response to Q14 regarding the treatment of ADC exposures under the SA, it is true loans that entail exposure to planning or construction risk are generally likely to present higher credit risk than loans against stabilised, income-producing property, or against construction projects that have been substantially pre-let or presold (in which case the source of repayment at origination of the exposure would not be relevantly “uncertain”).

Accordingly, the use of higher risk weights for such exposures than for most other IPRE exposures would not appear unreasonable in principle. However, there are two areas where the proposed approach would benefit from fine-tuning.

Build-to-rent residential (BTR)

One element of the solution to the UK's housing supply challenges is the small but rapidly growing institutionally owned and professionally managed residential rental sector. The challenges around mortgage affordability add to the current socioeconomic importance of BTR.

The lack of existing suitable stock combined with the structural shortage in the supply of new homes means that BTR typically involves the construction of apartment blocks or complexes specifically for rental. The scale of many of these schemes and the need to ensure that they can be operated efficiently for decades drive innovation both technologically through offsite precision manufacturing (modular construction) and through environmental, social and governance (ESG) features. For many reasons, it is a sector that should be encouraged; but does higher risk mean banks should be discouraged from financing it?

Unlike traditional build-for-sale residential (which can be sold off-plan) and traditional commercial development (which can be wholly or substantially pre-let), BTR schemes can only be stabilised through a letting-up process commencing after construction is more-or-less complete. But that inability to de-risk via presales or pre-lets does not mean that a BTR scheme is comparable in terms of credit risk to a speculative non-BTR development.

The structural housing supply/demand imbalance is so profound and pronounced that competent BTR developers and operators can have a high confidence level that their scheme will let. E With suitable protections against cost overruns and delays (which sufficient equity can address), the main risk is that targeted rents cannot be achieved – and lenders can underwrite on more cautious rental assumptions to protect against that. The fundamental risk that a speculative commercial development stands empty for years does not really apply in relation to BTR.

We would recommend an additional carve-out from the HVCRE category in the case of build-to-rent residential real estate so that bank finance can continue to support the growing and socioeconomically important institutional BTR market. It may be possible to achieve this by clarifying the “sufficient equity” carve-out at an appropriate level.

Funding capital expenditure and decarbonisation

We note that the HVCRE category is broader than the SA ADC exposure category, because it includes real estate “bought for speculative purposes” (although it is not clear what that means) and cases where “a change of planning use is sought for the real estate”. This is relevant, because of the degree to which capital expenditure (potentially involving a planning use change or a degree of speculative risk) is likely to need to be funded over the coming years.

As explained in our comments on the SA ADC exposure category, CRE investment and finance were traditionally seen as primarily involving assets changing hands or, to a much more limited degree, and involving structurally higher risk, being constructed. However, the coming years seem set to be characterised by a far higher focus on the assets themselves and their users.

The three most powerful drivers behind that are (i) changes in how we shop and use offices (revealed and accelerated by the internet, the GFC and the pandemic), (ii) changing occupier preferences (shorter leases and a growing appreciation of flexibility), and (iii) climate change and the need to decarbonise (with buildings having a big role to play in achieving net zero carbon targets).

Very many buildings will need either to be converted from one use to another (for example, from retail or office use to residential use), or substantially upgraded to meet more demanding sustainability requirements (including minimum energy efficiency standards). Some such repurposings and renovations are likely to require planning permission (and even where permitted development rights mean that they do not, a change of planning use is arguably nevertheless involved); or they might be undertaken in the context of strategies that might be described as speculative.

Responding to those drivers will deliver a better, more sustainable built environment that better serves the needs of the citizens and businesses that use it and that is both less damaging and more resilient in terms of climate change. Buildings (and building owners, and their financiers) that fail to respond to those drivers may end up requiring substantial, late capital investment to remain economically useful, to avoid finding themselves stranded with obsolescent buildings.

Senior Bank of England officials have noted⁷ that, if we are to meet the climate change challenge, banks need not merely to manage down their own institutional climate risk, but also to finance the decarbonisation and wider green transition of the economy and society as a whole – and in this context, more specifically, of the built environment, which [according to the UK Green Buildings Council](#) is responsible for 25% of total UK GHG emissions.

Assuming that the PRA, like us, agrees with that Bank of England view that banks should be financing this kind of activity, it is important that the risk weighting framework put in place to guard banks against construction and planning risk does not in fact disincentivise them from doing so. We would urge the PRA to clarify that where construction or planning risk arises in the context of financing asset management strategies that reduce carbon, climate and wider obsolescence risk, the financing will remain subject to IPRE Slotting rather than falling into HVCRE Slotting.

We note that, where HVCRE is in point because of the real estate having been bought for speculative purposes or because a change of planning use is sought, the “sufficient equity” let-out (which can apply in the financing of land acquisition, development and construction) is not available.

Preferential risk weight for short remaining maturity exposures

The current IPRE Slotting framework includes preferential risk weights for the Strong and Good categories if the remaining maturity of the exposure is less than 2.5 years. The IPRE financing market generally operates on the basis of relatively short tenor loans (three to five years) with no more than modest levels of amortisation during the life of the loan. Maturity risk is therefore structurally significant, as a distressed or illiquid market when the loan matures can impact on the borrower’s ability to refinance the loan or sell the asset to allow the loan to be repaid.

Clearly, a counter-cyclical lending strategy or at least sensible LTV levels can mitigate repayment risk for the lender; but the logic of reducing the risk weight solely by reference to the approach of loan maturity always seemed questionable. That was so regardless of any temptation for firms “*to artificially structure loans such that the remaining maturity is less than 2.5 years*” (although this regulatory framework undoubtedly created such a temptation).

For that reason, we support the proposal to add a condition that “the firm reasonably considers that the obligor could refinance the exposure in a severe but plausible stress in the refinancing market”, to the requirement for less than 25 years remaining until maturity, for the preferential risk weights in the Strong and Good categories to be available.

⁷ For example, Sarah Breeden in this speech: <https://www.bankofengland.co.uk/speech/2021/may/sarah-breeden-managing-the-impact-of-climate-change>.

Preferential risk weight for “substantially stronger” exposures

In the years since the UK’s IRB banks were moved to Slotting for their IPRE exposures, those banks have found it difficult to compete for commercial real estate lending mandates at low LTV levels against prime buildings, mainly because IRB banks from overseas could achieve much lower risk weights than the normal 70% rate applicable to Strong exposures under Slotting. That appeared to be an inevitable but not especially desirable consequences of the co-existence of the two approaches in the market.

The gradual introduction of minimum output floors is now serving to reduce the risk weighting advantage available to IRB banks. Alongside that shift, we support the proposed availability of the preferential 50% risk weight for IPRE exposures with “features which are ‘substantially stronger’ than the criteria specified for the strong category”.

This change further narrows the competitive disadvantage for UK banks subject to Slotting without, in our view, increasing the credit risk to which they are exposed (it might even reduce it, by refocusing more of their activity towards low risk IPRE lending).

However, the proposed criteria for the “substantially stronger” category are excessively narrow:

- The requirement that the transaction slots **Strong for each factor** strikes us as unnecessarily demanding.
- We would suggest that the requirement for the **leverage of the obligor to be “substantially below the market norm”** for a similar transaction is excessive. If you are determining the “market norm” by controlling for the transaction structure, sector, region and property location and quality, it is not clear what considerations are left as a result of which the leverage might end up being “substantially below” it. Also, if the market norm leverage level is already low, there may be no material incremental credit benefit in leverage being “substantially lower” still.

We would recommend requiring instead that the leverage level, transaction structure, sector, region and property location and quality should present “*substantially lower credit risk than is required to qualify for slotting as Strong*”. Thus, where an LTV of 55% would qualify for Strong, an LTV below 50% might qualify for the preferential risk weighting.

- The focus on **income quality** strikes us as sensible, but we would emphasise that most businesses, and thus most tenants, do not have a bond rating. As a result, unless this category is intended to be available only for the financing of properties occupied by the most blue-chip tenants (which might sit uneasily with the government’s levelling up agenda, as well as not necessarily perfectly aligning with low credit risk), the meaning of the words “or equivalent” will be important. A suitable approach might be found in methodologies that assess income quality by reference to the probability of failure by particular tenants and tenant categories (we are aware of such methodologies in the market).

Appendix 1

Key recommendations from [A Vision for Real Estate Finance in the UK](#)

Information, analysis and expertise

- 1. Loan database:** All lenders in the UK commercial real estate (CRE) market, regardless of type or location, should be required to collect and submit to a centralised database specified information about each UK CRE loan and its collateral, immediately upon making the loan and periodically throughout its life. The regulator should have full access in real time not only to the data, but also to individual lender and overall market risk analyses conducted on the basis of the data. There should also be controlled public access to the database.
- 2. Expertise and insight for the regulator:** The regulator should have access to expert interpretation and analysis of market information, particularly to give it insight into where in the cycle the overall market and individual market segments are likely to be at any particular moment. Expertise and insight from market participants and external experts should supplement and complement a well-resourced pool of CRE finance expertise within the regulator.
- 3. CRE finance qualifications:** Key members of CRE lending teams and credit functions with responsibility for UK CRE lending, regardless of type of institution, should have an appropriately accredited CRE lender qualification, maintained through continuing professional education.

Incentives

- 4. Use of long-term value measures for risk management:** For CRE lenders subject to regulatory capital rules, loan-to-value (LTV) based capital requirements should be linked to a long-term measure of collateral value that is insensitive to the investment cycle.
- 5. Better risk differentiation in regulatory capital requirements:** The basis for regulatory capital requirements should more accurately reflect the actual level of risk arising from CRE loans, with greater differentiation of capital requirements between loans with different risks. Very low-risk CRE lending (even if unrated) should be recognised as such for banks, including through the terms on which such loans may be used as collateral at the Bank of England.

A market structured for stability

- 6. Encouraging diversity:** The regulator's function should reflect the important role that can be played in promoting financial system resilience and stability by diversity of lender response (principally through diversity of lender types and lender strategies, and with a focus on the role secondary markets can play). Where possible, regulatory action should have regard to levels of diversity and seek to reduce barriers to entry, particularly for new or under-represented types of lender.
- 7. Regulatory governors, not switches, operating consistently across the cycle:** Regulators should use regulatory governors (including the application of sectoral and counter-cyclical capital buffers) that increasingly restrain regulated lenders as the CRE market rises above its full cycle average, irrespective of views about whether a CRE market crash is anticipated or considered unlikely. An explanation should be required where the regulator wishes to override that framework.

Appendix 2

How prudent valuation criteria could work with revised SA risk weightings for ‘regulated commercial real estate’ to promote the safety and soundness of firms and address potential financial stability concerns

1. Accept the BCBS risk weightings of 70% for LTVs up to 60%, 90% for LTVs up to 80% and 110% for LTVs higher than 80%. This is important for two reasons:

- First, greater risk sensitivity in risk weightings rewards SA banks for conducting lower LTV lending through lower regulatory capital costs. The PRA’s current proposals for 100% risk weightings for lending up to 80% LTV (and 110% for lending with LTVs greater than 80%) instead encourages them to stray further up the risk curve in pursuit of returns.
- Secondly, greater risk sensitivity in risk weightings both justifies, and makes use of prudent valuation criteria as a counter-cyclical framework (as explained below). Prudent valuation criteria are likely to have very limited impact if their only power is to trigger a rise from 100% to 110% risk weighting, where they affect collateral value in such a way as to tip the LTV to greater than 80%.

2. The importance of incentivising low-LTV lending is reinforced by Bank of America research⁸, which shows 60% (market value-based) LTV to be a meaningful tipping point for defaults:

LTV

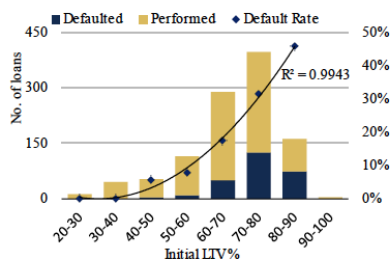
We found the initial LTV to be a good predictor of defaults but a weak predictor of Loss Given Default. Unsurprisingly, the likelihood of a loan defaulting increases as its LTV increases.

Just three loans with an initial LTV of less than 50% have incurred a loss, corresponding to a default probability of just 2.7% by number of loans. Of the 225 loans we observed with an initial LTV of 60% or less, 12 incurred a loss, corresponding to a probability of 5.3%. Above the 60% LTV level, the default rate rises sharply: 249 of 851 loans (29.3%) defaulted. This LTV tipping point could support using a 60% advance rate as the limit for the leverage of senior loans, above which junior or mezzanine debt would begin to attach, in our view.

Among the loans that had an initial LTV between 60% and 70%, 17.3% defaulted. This increased to 31.5% and 45.7% for loans with initial LTVs between 70-80% and 80-90%, respectively. There were two conduit loans written with an initial LTV above 90% and they were repaid in full.

In the UK, the same pattern was observed with a LTV tipping point at 60%. The default rate of loans with initial LTVs between 50%-60% was 7.1% rising to 19.0% between 60%-70%, 28.2% between 70%-80% and 55.8% between 80%-90%, as illustrated below.

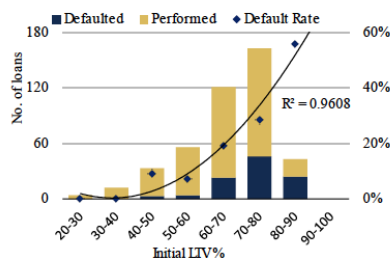
Exhibit 22: Default rate by initial LTV - All Europe
LTV is a good predictor of defaults



Source: Trepp, BofA Global Research

BofA GLOBAL RESEARCH

Exhibit 23: Default rate by initial LTV - UK only
58% default rate amongst highest LTV loans



Source: Trepp, BofA Global Research

BofA GLOBAL RESEARCH

⁸ This research, based on the relatively rich data available from the securitised CRE debt market, is available here: https://hubble-live-assets.s3.amazonaws.com/crefc/file_asset/file/792/BofA_research_-_which_European_CRE_loans_defaulted_and_why_March_2023_update_.pdf.

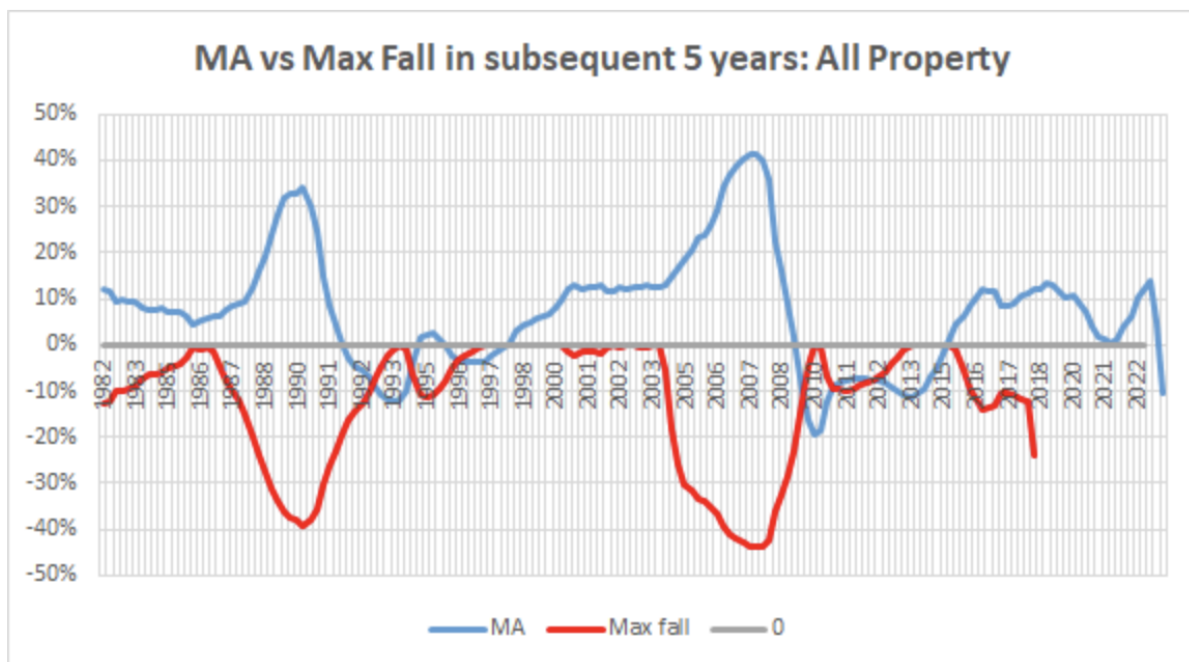
3. We recommend using a model at the market level, not the sector level, because:

- in major downturns, sectors are likely to behave in similar ways, and
- structural shifts that see value move from one sector to another (the impact of online shopping on the Retail and Industrial/Logistics sectors is a good example) should not confuse a market-level model, but may lead to odd signals at sector level.

4. It would be essential to use a model that has been tested on historical data and shown to be able reliably to indicate when the market appears to be overheating and how to adjust market values in response. There are various options here, none of which, unfortunately, have been road-tested by regulators or regulated firms in any organised way over the last few years (an opportunity we were highlighting in 2017, which was sadly missed). It is impossible to guarantee the predictive capabilities of any model, so humility is essential: whatever approach is used, it should remain under review and alternative approaches should continue to be investigated.

The simplicity and ease of use of an approach is almost as important as its accuracy. As we believe it passes both simplicity and accuracy tests, and because it is easy to present, we have used the Adjusted Market Value (AMV) approach described in the 2017 Long-term Value Methodologies and Real Estate Lending report⁹. This is a very simple approach that has been successfully tested against historical data. It would be straightforward to use it to adjust market values (and thus LTVs and risk weightings) in a consistent way to reduce property cycle risk across the banking system.

AMV is an empirical approach that compares the UK CRE market capital value index adjusted for inflation to its own long-term trend (the x-axis in the chart below) – the blue line shows the difference between the index and its long-term trend (the market adjustment or MA). By plotting the maximum fall in that index over the next five years (the red line), the model provides an indication of the relationship between particular levels of market overvaluation and the likelihood that a significant market correction is not far behind. That can in turn be used to adjust market values, LTVs and risk weightings.



⁹ The report, which was the result of further work on Recommendation 4 of the Vision report, is available here: https://hubble-live-assets.s3.amazonaws.com/crefc/file_asset/file/289/Vision_R4_long_term_value_methodologies_report_June_2017_.pdf.

5. The model must provide a sensible basis for market values to be adjusted, having regard to how the impact of adjustments feeds through to risk weighting. The AMV model does so, suggesting that market-level overvaluation of more than around 15% indicates a very high likelihood of a market fall of 30% (as shown in the 2017 report):¹⁰

Using AMV as a Macro Indicator

The approach would be to monitor quarterly AMV outputs relative to market value and identify the percentage overvalue (the market adjustment), which indicates, based on historic experience, that there is an unacceptably high risk of a material downturn in values. Figure 9, which is based purely on the historic IPD data set from 1972, plots the percentage of identified overvalue against the maximum actual fall in values over the next five years. The percentages in the table show the correlations and thus the probability that a given level of overvaluation will result in a given fall. It can be seen that at 10% overvalue, there is a 50% chance of a fall of up to 30% and a 34% probability of a fall of 35%. At 20% overvalue there is a very high probability of a major fall.

Figure 9: **Correlation between AMV overvalue signals and actual subsequent five-year value falls**

Overvalue indicated by AMV (Market adjustment)	Probability of value fall of specified percentages over next five years				
	-20%	-25%	-30%	-35%	-40%
10%	56%	54%	50%	34%	14%
15%	100%	96%	88%	65%	27%
20%	100%	100%	100%	81%	33%
25%	100%	100%	100%	94%	44%
30%	100%	100%	100%	100%	54%
35%	100%	100%	100%	100%	100%

Sources: MSCI and LTVSV Group Analysis

A 60% LTV loan becomes a roughly 85% LTV loan if the value of the collateral falls by 30%. A 35% fall in collateral value would take a 60% LTV to more than 92% LTV. Being able to read across from particular levels of market overvaluation to the likely level of value falls and their impact at different LTV levels is extremely useful if we want to develop market adjustment factors to apply prudent valuation criteria.

6. We would recommend clear guidance as to how the model should be used to adjust market values in the interests of consistency and avoiding unnecessary disruption in the market. Our suggestion, based on the data we have seen and this model, would be along the following lines. The key principle should be that collateral values are adjusted:

- to increase risk weighting by increasing the LTV (hence the importance of greater risk sensitivity in the framework, as recommended by the BCBS rather than as proposed by the PRA – point 1. above),

¹⁰ While it is too early to judge from the perspective of 2022, the value fall that we have seen since late 2022 is broadly in line with the model's predictions: overvaluation of around 13% in 2018 has been followed by a fall of around 25%.

- when (and only when) the data and the model indicate that the market is overheating such that the relevant real estate is over-leveraged.

Thus:

- **Where the LTV is no higher than, say, 40%**, prudent valuation criteria should have no effect at all and market value can be used without adjustment (it would be a truly exceptional property crash in which values fell to such a degree as to threaten lenders with exposures at this level).
- **Where the LTV is between 40% and 50%**, adjust collateral value **only if** the model indicates market overvaluation of 35% or more; the adjustment should be sufficient to tip the LTV of the loan from the up-to-60% LTV risk weighting category into the greater-than-60% LTV risk weighting category.
- **For LTVs greater than 50%**, adjust collateral value **only if** the model indicates market overvaluation of 15% or more; and the adjustment should be such as will tip the loan from the LTV risk weighting category it would fall into based on market value, into the next risk weighting category. So for risk weighting purposes, an ostensibly 55% LTV loan would become a greater-than-60% LTV loan, and a 65% LTV loan would become a greater-than-80% LTV loan.

Concluding remarks

An approach such as is outlined above would elegantly and simply put counter-cyclical protections in place in a way that is consistent with the objectives of the 2017 Basel 3 finalisation framework. It would be simple to implement, and would avoid both significant market disruption and the confusion and inconsistency that might result if the valuation profession and banks are left to figure this all out themselves. The approach remains rather crude (we would prefer more, and more different, LTV risk-weighting buckets even than the three recommended by the BCBS), but it can achieve the policy objective. The application and interpretation of the model, and indeed the specific choice of model used, could – and indeed should – be kept under review and modified as required from time to time.

We do not believe that the goal of reducing the vulnerability of banks to the property cycle can be achieved if the PRA persists with its proposed risk weighting categories, which are too few, too high and insufficiently differentiated (100% and 110%, around the 80% LTV tipping point). Achieving the policy objective is only possible with more, and more different, risk weighting categories (at least the three recommended by the BCBS at 70% for LTVs up to 60%, 90% for LTVs up to 80%, and 110% for LTVs greater than 80%).

We would make two final points in closing:

- While we are not entirely convinced about the proposed focus on valuation at origination, for a counter-cyclical measure like this it is entirely appropriate. The goal is to reduce leverage appetite at the point of origination by helping banks look past market values at the property cycle context (not to increase RWAs on the existing book in response to external events – which is pro-cyclical).
- Ideally, the risk weighting framework should not only discourage banks from lending at high LTVs when the market is overheating. The same market data and models that can help achieve that objective can also be used to achieve the opposite – namely, to encourage banks to provide credit in early-stage recovery markets, by adjusting market value *up* (and LTVs *down*) when it is safe and appropriate to do so. We do no more than mention this, because it seems a long way from the PRAs starting point, and because we see virtue in consistency with Basel 3 (which regrettably does not contemplate such an approach). For now, we would be content to see the PRA steer closer to Basel 3, rather than diverge from it in the way proposed.