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BPF
BRITISH PROPERTY FEDERATION

BPF comments on the report of the high-level expert group on reforming the structure of the EU banking sector

Background

The British Property Federation (BPF) is the voice of property in the UK, representing businesses developing, owning, managing and investing in real estate. This includes a broad range of businesses comprising commercial real estate developers and owners, financial institutions, corporate and local private landlords and those professions that support the industry. Our membership includes both traditional real estate companies and groups, and real estate investment fund management organisations.

We have shared this document with the Zentraler Immobilien Ausschuss (ZIA – the German Property Federation), who agree with the comments below, and we agree with the thoughts expressed in ZIA's response.

We welcome the opportunity to comment on the report of the high level expert group (HLEG) on reforming the structure of the EU banking sector. We set out below some comments on certain issues raised by the report with a potential impact on the European commercial real estate sector.

Submissions

We support the aims of the HLEG to ensure that banks move towards a more sustainable and robust business model. However, we would like to limit our submissions to making two headline observations, and commenting in a little more detail on the two proposals in the report which are specifically relevant to the real estate sector, which is identified in the report as having attracted excessively risky lending with inadequate capital protection in the lead-up to the financial crisis. These proposals are the reconsideration of the capital requirements framework for real estate lending, and maximum loan-to-value (and/or loan-to-income) ratios as instruments for micro- and macro-prudential regulation.

Headline observations

While the linkages between banking market stability and real estate are familiar and widely debated, there is little sign of any serious review of the structure of real estate finance markets as a whole at the European level (or, indeed, at the national level in the UK). The HLEG has produced an excellent report on reforming the structure of the EU banking sector, and that report includes specific proposals relating to real estate lending. But the EU (like the UK) desperately needs to move – and is gradually moving – towards a more diversified and resilient real estate finance market which is less dominated by traditional bank lenders. Capital (including debt) is the life blood of the real estate industry: without it, our built environment cannot be maintained, let alone improved to ensure that it remains fit for the purposes of changing societies and economies undergoing rapid technological development, and to help achieve a more energy efficient and environmentally sustainable future. **It is vital that the provision, across the cycle, of adequate capital (including debt) to the real estate industry is considered in a more holistic and strategic way, and not merely from the point of view of reducing risk in the banking system.**

As regards the report's proposals relating to real estate lending by banks, our headline point is that **the regulatory challenge is to reduce the tendency of banks' real estate lending behaviour to exaggerate the ups and downs of the real estate cycle; it is not to create new incentives for banks simply to reduce their real estate exposure**. Banks generally lend over-exuberantly during a boom, then withdraw capital after a crash (and it is notable that in both phases of the cycle, a herd mentality tends to operate); that is also what has happened in this financial crisis.

The real estate sector is heavily reliant on capital, including loan finance, to perform its economically useful functions of upgrading the built environment and employing the construction industry and the other non-financial supply chains (from building parts manufacturing to buildings maintenance and facilities management) which support it. The UK and European real estate industry is currently suffering from retrenchment by the banks as well as from the generally weak and uncertain economic climate. Any regulatory changes designed to make real estate lending by banks safer must be managed carefully to avoid exacerbating the problems we face today, and help avoid the mistakes of the past when confidence returns.

Comments on the proposals specifically relating to real estate

Capital treatment of commercial real estate related lending

As noted in the report, systemic banking crises are often preceded by excessive real estate lending, often made with a poor understanding of the risks involved and with the result that insufficient capital is set aside to cover potential losses on that lending. Excessive lending to real estate businesses encourages rapidly rising asset values and creates the conditions in which a price bubble can develop. Real estate bubbles and their subsequent painful deflation can have significant negative implications for real estate businesses. Accordingly, **we support measures to ensure that the capital adequacy framework includes safeguards against real estate market stress**.

However, the implementation of measures to achieve this, such as robust floors on the RWAs calculated by internal models, should be carried out at the right time and in the right way, after consideration of the potential implications that they would have on real estate lending and on the wider economy – bank safety is not the only important consideration here. **Starving the real estate industry of capital has serious implications for (among other things) the construction industry, and for how confident citizens and businesses feel about the buildings and wider environment in which they operate and, by extension, about their future prospects**.

It is also important to be mindful of the risk that regulatory intervention may distort bank perceptions of the relative risks of different kinds of lending. Secured lending against income producing commercial real estate can represent a very low risk indeed, depending on the quality of the borrower, the reliability of the underlying rental cash flows, the terms of the loan and underlying lease(s), and the broader specification and characteristics of the building and its location. Banks traditionally like such lending partly because it really **is** relatively easy to assess its risk, compared to, say, a retail, manufacturing or professional services business (ignoring the perceived or actual relative merits from a policy perspective of capital allocation as between those sectors).

It is important not to confuse effective risk assessment with policy goals for the allocation of capital. If tougher capital requirements specifically targeting real estate lending strongly diverge from any reasonable assessment of the real economic risk of such lending relative to other kinds of lending, banks' lending decisions may be distorted, resulting in the build-up of different forms of systemic risk. For example, the pain of deleveraging after over-exuberant lending to non-financial and non-real estate SMEs or private individuals might be even greater than that following the bursting of a

real estate bubble. **The real problem is the cyclical tendency of banks to lend too much on the way up and to retrench too sharply in a downturn; it is not real estate per se.**

Finally, we note that the report recommends that the capital treatment of real estate risks should be more harmonised in order to produce greater confidence in the adequacy and consistency of the IRB-based capital requirements. We strongly agree with the report that **there must be continuous improvement of risk models**, and are troubled by the decision of the UK Financial Services Authority (FSA) to abandon faith in IRB-based models for income producing real estate altogether, and instead transition the entire UK banking sector onto the relatively crude 'slotting' approach, even as bank deleveraging is accelerating and much of the UK real estate sector is facing a worsening credit drought. We would prefer to see the FSA make proactive use of the possibility to modify real estate risk weights based on the economic cycle, as recommended in the report.

However, a move to enforced harmonisation and consistency as a policy objective in itself seems almost certain to result in new systemic risk build-up, because risks cannot safely be assessed in an entirely objective way without perfect knowledge. As no-one has perfect knowledge, we believe **regulators should focus on encouraging better collection and management of real estate lending data to support better IRB-based models**, and not on requiring all banks (which will inevitably have different experience, expertise, customer relationships and business models) to assess risks – which may look 'similar', but almost certainly aren't exactly what they seem to be – in the same way.

Loan to value (LTV) / loan to income (LTI) ceilings

As noted above, in the interests of mitigating the potentially damaging effects of real estate bubbles for businesses that operate in the sector, we are generally supportive of prudential tools which might operate on a counter-cyclical basis, including to cool overheating real estate markets. Subject to a number of important caveats, it is possible that maximum LTV/LTI ratios could, if implemented correctly, have a role to play. We assume, for these purposes that the HLEG's proposals relate solely to asset specific 'income producing real estate' lending, and not to corporate facilities that are secured on real estate.[1]

The first and most important caveat is that **any caps should operate on a 'once and for all' basis by reference to the ratio that exists at the time the loan is made**, rather than dynamically on a continuing basis. It is at the point a loan is made that a decision is made, and it is decisions that this approach should seek to influence. On the other hand, applying caps on a dynamic/repeating basis during the life of a loan would require new capital from borrowers at precisely the point when real estate values are falling and they are least likely to be able to deliver. Such a pro-cyclical use of caps would be more likely to cause than to avert problems in the real estate finance market, especially when the whole market is undergoing a correction.

A second, very important, caveat is that LTV/LTI caps are only capable of working effectively in relation to investment properties producing a stable income – it is common for such loans to be made subject to LTV and interest or debt service cover financial covenants. By contrast, **LTV/LTI caps would not work in the context of development projects** – and it is often through development that the real estate industry makes its most valuable contribution to the economy. In the current

[1] While the rationale for excluding secured corporate facilities differently should be obvious, it may be worth clarifying our focus on asset specific loans. For a major real estate developer-investor, a portfolio securing a loan facility will change over time as different buildings enter different stages of their lifecycles. For example, it may make sense for an ageing building to be emptied of its occupiers so that the owner can redevelop it – a reduction in income will be inevitable, but temporary; it would be inappropriate for a mandatory LTI cap to cause problems.

environment, development finance has all but disappeared – but when it is available, the financial analysis is amenable neither to LTV ratios (as the value itself depends on the expenditure to be financed) nor to LTI ratios (as there will be no income during the construction phase of a project). Cost is often a more meaningful measure than value in this context, and income is likely to be assessed by reference to future contracted income in the form of pre-lets.

Unfortunately, the obvious simple solution of carving development out and dealing with it differently would not work, because there is no clear dividing line between investment and development: major refurbishment and adaptation or conversion to different uses may be carried out by long term real estate investors who might not be naturally classified as developers. Furthermore, businesses may use their mature investment sites to fund more speculative developments (or refurbishments or conversions); and building lifecycles mean that income producing assets will periodically become redevelopment opportunities (without necessarily changing hands).

Development projects with a significant **housing** component may throw up particular issues which must also be carefully considered; and the financing of investment transactions involving UK residential property for rental gives rise to similar problems as regards LTI caps, because it is common for homes to be purchased vacant with a view to securing tenants who will provide an income in due course. On a related note, it is not entirely clear whether the LTV/LTI proposals are to apply to owner-occupied residential real estate as well as that purchased for investment purposes. If that is the case, the proposals may well have implications for countries (such as the UK) which are currently actively encouraging additional bank lending in this area (including at high LTVs) as part of efforts to stimulate house building and promote home-ownership.

It would be disastrous if the introduction of LTV/LTI caps designed to enhance micro- and macro-prudential stability had the effect of crippling highly valuable economic activities which form a core part of every country's national investment.

Finally, the proposals for LTV/LTI caps need to be tied back to our high level observation about the importance of a broader perspective and regulatory vision for real estate finance as a whole. In other words, it is important to look at banks' real estate lending not only as part of a consideration of the structure of the banking sector, but also in the context of the financing of real estate more generally, having regard to the full range of potential lenders (across the banking sector, pension funds and insurance firms and specialist real estate lenders) and the full range of financing options (ranging from traditional senior debt through gradations of mezzanine to pure equity). **What would be the impact of LTV/LTI caps restricting bank lending on other potential elements of, and contributors to, the capital structure of a real estate asset or business?**

None of the above should be taken as a rejection of the HLEG's proposals. However, we believe the perspective of the HLEG's report needs to be complemented by a broader real estate perspective. If these policy proposals are to deliver their intended outcomes without negative unintended consequences, **it is vital for these policy proposals to be explored (alongside other possible approaches) in discussion <u>with the real estate industry</u>** so that the many potential pitfalls can be negotiated as successfully as possible. Consulting with the banking industry alone, as both the European and national authorities are often prone to do, is not sufficient: if the banks had a sound and reliable understanding of real estate markets, their approach to real estate lending risk over the past decade might have been very different.

We remain at your disposal should you wish to discuss any of the points above in more detail. Please contact Peter Cosmetatos (+44 20 7802 0115, pcosmetatos@bpf.org.uk) in the first instance.