Sustainable commercial real estate debt markets in Europe and the role of regulation

Peter Cosmetatos, CEO, CREFC Europe

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The European CRE market

- CRE is a key “enabler” in the economy – the ability to rent professionally managed premises allows flexible use of resources by non CRE businesses
- At EU level, CRE contributes more to employment and gross value added than banking, automotive or telecoms*
- Debt is a vital element of the capital required for most CRE activity, especially outside prime CRE in gateway cities
- CRE is a highly cyclical market, connected to debt markets by strong pro-cyclical feedback loops
- CRE debt is also a potentially attractive asset class for investors seeking stable long-term income

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The European CRE debt market

- For investors, debt investment is lower risk than equity investment – but concentrated debt exposure to a cyclical asset class poses risks to financial stability and the economy
- Balance sheet banks very dominant in CRE debt market
- CRE debt market data is scarce and unreliable
- Lender distress is very concentrated and very opaque
- Resolution is vital to unblock credit flow and investment activity – but balancing protection of borrowers, lenders and the public finances is a difficult juggling act

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The regulatory context

- Regulators have been particularly hostile to CRE and securitisation since the financial crisis (the regulatory cycle in action!)
- Post-crisis regulation penalises regulated firms investing in securitisations, relative to other investments
- In late 2012, efforts began to rehabilitate “high quality” securitisations to improve (a) credit flow to the real economy, and (b) liquidity and risk transfer for Europe’s banks
- That work continues, but will fail for CRE debt, despite its economic and systemic significance, because while regulators may fear CRE and CRE debt markets, they still do not understand them
- Penalising securitisation of CRE debt means that investors and the real economy, as well as transparency, liquidity and diversity in CRE debt markets, will suffer

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How *not* to regulate securitisation*

- Solvency II imposes penal capital charges on insurance firms investing in "Type B" securitisation
  - Commercial mortgage backed securities (CMBS) mandatorily treated as Type B because of high volatility during the crisis
- EBA proposals for "simple standard and transparent" securitisation effectively exclude securitised CRE debt
  - Criteria require fully amortising loans with full recourse to borrowers that are not special purpose vehicles (SPVs)
- New Basel securitisation framework penalises low "granularity", assessing it by reference to the number of borrowers

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Turning to Greece…*

- Data / transparency
- Market structure / concentration
- Speed of progress in resolving legacy loans?
- Resolution strategy – a bad bank or within individual banks?
- Resolution of legacy needed both to get the economy moving again, and to build a more resilient, diverse CRE debt market
- Resolution ultimately requires private/foreign capital. What can Greece do to attract it?

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Strategic actions for the financial regulator*

- Improve data / transparency of CRE debt market
  - especially in the banks
  - to benefit existing market participants, new entrants, and regulators
- Promote diversification to create an investible asset class
  - sales of non-performing loan (NPL) portfolios to resolve legacy
  - private/foreign capital (e.g. CRE debt funds) can also originate
  - securitisation for secondary market liquidity as well as risk transfer
- Above all, don't waste a perfectly good crisis!

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