BPF/INREV/ZIA response to FSB consultation on the oversight and regulation of shadow banking

Background

The BPF, INREV and ZIA[1] welcome the opportunity to respond to the FSB's Consultative Document (CD) on strengthening the oversight and regulation of shadow banking. We set out below some high level comments on certain issues raised in the CD. **Appendix 1** contains our responses to particular consultation questions.

Key messages

We support the FSB's objective of ensuring that shadow banking activities are subject to adequate oversight and regulation in order to mitigate the bank-like risks that such activities pose to financial stability. We also support the FSB's high level policy framework for overseeing shadow banking activities, and **in particular agree that the 'economic function' approach to determining the scope of any policy measures in this area is superior to any approach based on entity-type**. Given the enormous and dynamic diversity in business models, risk profiles and regulatory frameworks across jurisdictions, setting the scope by reference to entity-type is likely to lead to 'collateral damage', as regulation could be imposed on entities which may be of the same type as genuine shadow banks but carry out very different activities and pose no bank-like risks. It would also be an invitation to regulatory arbitrage.

However, we are concerned at the generally poor level of understanding among financial regulators of the real estate industry. They tend to regard real estate as little more than a risk, forgetting the vital role this industry plays in the real economy, as well as the fact that, for lenders, it offers a very broad range of risk propositions, from the very safe to the very risky. As an industry that is highly reliant on capital inflows (to deliver the capital investment that the built environment requires), it needs a stable, diverse and resilient range of funding sources across the cycle. That environment is one that would also benefit the stability of the financial and banking system. Shadow banking regulation should encourage its emergence.

As banks across Europe continue their retreat from lending to real estate businesses, other entities have slowly begun to enter the real estate lending market. These include insurance companies, pension funds and specialist debt funds. These provide an important source of capital at a time when the industry most needs it, and are helping the sector to get back on its feet, thereby

[1] Three of the principal European organisations representing investors in real estate – please see **Appendix 2** for more information about each of these organisations.

enabling real estate to contribute to the growth of the real economy. These new sources of finance for the European real estate sector also offer the hope of a more diverse and resilient range of financing sources in the future for a sector that has been very heavily dependent on banks.

It is vital that any regulatory framework for shadow banking is implemented in a proportionate manner that does not compromise these systemically valuable, important developments. Setting the scope too wide or interpreting terms such as 'liquidity and maturity transformation' too broadly risks imposing regulation on businesses which carry out totally different activities to banks and have completely different risk profiles. This in turn could stymie useful economic activity, delay the return of sustainable growth to European economies and prevent structurally useful diversification in finance markets.

We therefore agree with the FSB's comments in the CD that authorities' approach to shadow banking should be a targeted one, which addresses bank-like risks to financial stability but does so in a proportionate way, focusing on activities which are genuinely material to the financial system. Regulators should consider setting *de minimis* thresholds for the application of shadow banking regulation to filter out systemically insignificant entities.

Unfortunately, these comments are not given a very high profile in the CD, appearing only in the introduction. It is unfortunate that they are not included elsewhere as a reminder to readers (in particular regional and national regulators) that the myriad oversight and regulation proposals should be implemented only where particular activities are giving rise to genuinely systemic risks to the financial system. We are concerned that over-zealous regulators – understandably very cautious after the financial crisis – will in their desire to de-risk the system take a 'just in case' approach that is unnecessarily (and potentially harmfully) broad. There is a risk that the CD's policy tools end up being implemented too generally. In particular, an approach that hinders the emergence of new entrants and specialised lenders into finance markets could result in structurally higher levels of systemic risk, rather than the safer, more stable environment we would all like to see.

Accordingly, we would welcome additional guidance from the FSB reiterating the points made in the introduction to the CD regarding the necessity of a targeted and proportionate approach to implementing the policy measures set out in the CD. We also recommend in **Appendix 1** that the FSB provides additional clarification in relation to certain scope questions to provide relevant guidance for regional and national regulators on these matters.

We remain at your disposal if you would like to discuss in more detail any of the issues raised in the CD or this response. Please contact Ion Fletcher (details below) in the first instance.

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Appendix 1 – detailed response to consultation questions

Q2: Do the five economic functions set out in Section 2 capture all non-bank financial activities that may pose shadow banking risks in the non-bank financial space? Are there additional economic function(s) that authorities should consider? If so, please provide details, including the kinds of shadow banking entities/activities that would be covered by the additional economic function(s)
As noted under 'general comments' we agree with the FSB's approach of identifying the economic functions carried out by shadow banking activities rather than trying to identify the entities which carry them out. We have no particular thoughts on what additional economic functions should be considered by authorities, but we feel it would be beneficial for national regulators if the FSB could provide more detail in relation to the following questions of scope. **Management of client cash pools with features that make them susceptible to runs** *'Bricks and mortar' investors* The principal objective of the vast majority of real estate investors is to invest in 'bricks and mortar'; real buildings which provide businesses and individuals with the accommodation they need in order to thrive. They are fundamentally 'real economy' businesses whose activities (most tangibly construction and facilities management – but also further up the supply chain) employ millions of people across Europe. Such businesses are not involved in credit intermediation, although they may borrow – as any normal business would – in order to achieve the most appropriate capital structure. Whilst some 'bricks and mortar' real estate funds possess characteristics that may make them susceptible to runs (some open-ended real estate funds may have relatively generous redemption policies and may guarantee redemption at NAV notwithstanding the relatively illiquid nature of their underlying investments), our view is that these entities do not give rise to bank-like risks and their activities should therefore not be treated as shadow banking. Just like all 'bricks and mortar' investors, they are 'end-users' of credit, not credit intermediaries. Furthermore, such businesses are often already regulated entities; in the UK and in Germany they are subject to liquidity requirements and leverage restrictions. Germany also imposes limits on what proportion of a portfolio can be made up of an interest in a single asset. In light of our comments above, it should be self-evident that 'bricks and mortar' real estate investment (including that carried out through an open-ended structure) should not be treated as shadow banking. However it would be helpful for the FSB to clarify what it means by 'financial products' at section 2.1 of the CD; in particular, to confirm that investments in real estate (and other real assets) should not be treated as financial products[2]. Such guidance is needed because in our experience there is a persistent lack of understanding among regulators as to the activities carried out by real estate businesses. Perhaps owing to certain historic (and notorious) episodes of excessive or imprudent bank real estate lending, regulators we speak to often reflexively assign a high level of risk to real estate investment businesses and attribute to them intermediation functions that they are not actually performing. Indeed, in its 2012 Financial Stability Review the Bundesbank classed open-ended real estate funds as part of the shadow banking sector, even though they do not perform activities which

[2] In this context it should be noted that real estate assets are often indirectly owned by investment funds through holding structures put in place for various commercial and tax reasons. Hence, whilst the immediate assets of a real estate fund may be shares and other interests in different types of entity (which may technically be viewed as 'financial products'), the fund should not be considered to be investing in financial products where its underlying assets consist of real estate (or other real assets).

give rise to bank-like risks. Also, in preparing the European Market Infrastructure Regulation (EMIR), the EU classified real estate investment funds as 'financial counterparties', even though the way in which they use derivatives is fundamentally 'commercial' and 'non-financial'. The only justification given for that misclassification was a desire to avoid opening loopholes or making special provision for particular types of entity.

Without further guidance from the FSB there is a real risk that regional and national regulators may be tempted – through poor understanding or an excess of caution – to treat real estate investment businesses as 'financial' organisations and implement regulation that unnecessarily and inappropriately stymies their useful economic activity.

Real estate debt investors
In our view an open-ended real estate fund which gains investment exposure to real estate through lending against property is investing in 'financial products' and may give rise to bank-like risks. We would envisage that – to the extent that such funds have features such as unrestricted redemption policies, which make them susceptible to runs – they could be considered to be carrying out economic function 1. Such funds are rare, however, and are unlikely to pose real system risk.

Loan provision that is dependent on short term funding
As stated in section 2.2 of the CD, non-bank lending may give rise to bank-like risks as a result of maturity and/or liquidity transformation. Unfortunately there is some ambiguity in the language of the CD: whilst the economic function is *loan provision <u>that is dependent on short term funding</u>* (emphasis added), section 2.2 appears to redefine the economic function into a core element of lending to businesses that are cyclical in nature (such as real estate), which can be compounded by a second element; funding this lending on a short term basis.

It is unclear whether the FSB considers specialised lending to be a significant risk in itself, or whether the real risk only arises when that lending is funded by deposit-like or wholesale means. In other words, does there need to be maturity transformation in order to trigger shadow banking regulation?

Specialist lenders can carry out a valuable role in real estate financing, providing capital at times when mainstream lenders have retrenched. To the extent that there is a significant mismatch between the maturity of the loans made by these lenders and the way in which those loans are financed, we agree that bank-like risks arise and that appropriate supervision is needed.

However, if a lender takes care to match its funding and lending maturities, the risk of a sudden run is more remote (as the fund's investors may have limited redemption or exit rights, and cannot 'run to the exit' in the event of a market shock). There is clearly a far smaller chance of bank-like risks emerging under this model. We believe that national regulators would find additional commentary from the FSB helpful in determining to what extent lenders which do not perform significant maturity transformation should be subject to shadow banking regulation.

Securitisation and funding of financial entities
Securitisation is a fairly broad term and potentially encompasses a variety of financial structures. Some of these will give rise to significant bank-like risks and others to none at all. It is important that any shadow banking regulation acknowledges this spectrum and applies only where the bank-like risks reach a certain qualitative threshold.

In particular, we believe that straightforward whole business securitisations (whereby all or part of a business's assets are transferred to a special purpose vehicle which then issues bonds – typically of a maturity matching that of the underlying assets – secured on those assets) do not seem to us to give rise to shadow banking risks. Similarly, we do not consider that a listed real estate company which issues bonds secured on a particular pool of assets is carrying out shadow banking activities.

Once again, in order to encourage a consistent approach among national regulators, it would be helpful if the FSB could provide additional commentary on the range of securitisation structures, and clearly define the kind of arrangements which should be treated as shadow banking.

Q4: Do you agree with the policy toolkit for each economic function to mitigate systemic risks associated with that function? Are there additional policy tool(s) authorities should consider?

The CD identifies a number of different policy measures which could be adopted to mitigate the bank-like risks arising from different economic functions. It is right that regulators should have access to a wide range of tools in order to adequately address unsustainable build-ups of financial sector risk. Indeed, European regulators already make use of many of the tools identified in the CD.

As with all regulation, care needs to be taken to implement it in a way which helps to control risk while not impeding genuinely valuable economic activity. Accordingly, any measures designed to set limits on asset concentration or limits on investments in illiquid assets must recognise that in many cases specialist credit investment funds which invest in illiquid assets (for example, real estate debt funds) are an integral part of a diversified lending market. A diversified lending market is better able than non-diversified markets to withstand banking crises and better able to assist the real economy to recover from recessions. We would disagree with any proposal that sought to prevent specialist real estate lenders from operating in the market.

There is no explicit suggestion in the CD that the FSB is opposed to specialist lending, but we are concerned that regional and national regulators may in some cases interpret some of the language in sections 2.2 and 3.2.2 as indicative that specialist lending poses more of a risk than in reality it does. Based on that understanding they may seek to actively discourage it, with negative consequences for growth and employment.

As noted in our general comments above, we would encourage the FSB to communicate more forcefully the need for shadow banking regulation to be implemented in a proportionate manner which does not dilute the many benefits of a healthy shadow banking sector, nor starve important industries, such as real estate or infrastructure investment, of the access to capital that they need.

Appendix 2 – About the organisations making this submission

About the BPF

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.

About INREV

INREV is the European Association for Investors in Non-listed Real Estate Vehicles. Since its launch in 2003, it has grown to almost 350 members from more than 28 different countries. INREV's aim is to improve the accessibility of non-listed real estate funds for institutional investors by promoting greater transparency, professionalism and standards of best practice. INREV is led by institutional investors and supported by other market participants such as fund managers, investment banks, academics, lawyers and other advisors. As a pan-European body, INREV represents a unique platform for sharing knowledge on the non-listed real estate funds market.

About ZIA

The German Property Federation ZIA (Zentraler Immobilien Ausschuss) is a membership organisation founded in order to represent the interests of the whole real estate industry. We pursue the objective to create an environment in which real estate investments can prosper. Therefore ZIA advocates the interests of the German real estate industry vis-à-vis the political decision makers in Germany and in the EU. Our more than 140 members – including the biggest companies in the property industry - represent the industry at any stage of the supply chain. Our membership also includes a various number of property linked associations. ZIA was founded in 2006 and is a member of the Federation of German Industries (Bundesverband der Deutschen Industrie)