EBA's Consultation Paper dated 11 May 2015 (EBA/CP/2015/09): Draft Regulatory Technical Standards on assigning Risk Weights to Specialised Lending Exposure under Article 153(9) of Regulation (EU) No. 575/2013 (CRR).

Introduction

This is Grosvenor Group Limited's ("Grosvenor") response to the EBA's Consultation Paper dated 11 May 2015 (EBA/CP/2015/09): Draft Regulatory Technical Standards on assigning Risk Weights to Specialised Lending Exposure under Article 153(9) of Regulation (EU) No. 575/2013 (CRR).

About Grosvenor

Grosvenor is a privately owned real estate investment, development and fund management organisation, which manages or has economic interests in Euro 16 billion of commercial real estate in Europe, the Americas, Asia Pacific and Australasia. Grosvenor publishes an Annual Review and Annual Financial Statements, which along with other information can be found at www.grosvenor.com.

With a history of real estate investment which can be traced back over 300 years, Grosvenor is a long-term investor with a strategy which transcends economic and real estate cycles. Grosvenor is particularly focussed upon mitigation of the impact of market crashes, most clearly demonstrated by supporting Nick Scarles' chairmanship of the Real Estate Finance Group ("REFG"). The REFG produced its final report: "A Vision for Real Estate Finance in the UK. Recommendations for reducing the risk of damage to the financial system from the next commercial real estate market crash," in May 2014 ("Vision Report"). The Vision Report contained seven principal recommendations (to which this response refers) designed to protect financial stability while supporting the significant contribution which commercial real estate makes to economic growth. The Vision Report is available at www.ipf.org.uk/resourceLibrary/a-vision-for-real-estate-finance-in-the-uk--may-2014-.html.

Response to consultation

Grosvenor is pleased to have the opportunity to respond to the consultation and prepared to engage further as the proposals develop.

Grosvenor's response is limited solely to income producing real estate ("IPRE") and does not therefore cover any of the other specialised lending categories covered by the consultation.

Grosvenor's principal comments in response to the consultation are as follows:

- **Simplicity is good, but it must leave room for judgment.** There is much to be said for a relatively simple and transparent approach to regulatory capital, but achieving that should not be at the price of an excessively crude or mechanistic approach to assigning risk weights.

- **Regulatory risk weights should be aligned with economic risk.** The capital required to be held by lenders which are subject to supervisory slotting in respect of IPRE lending should as far as possible reflect the actual level of commercial risk associated with that lending. See Vision Report, Recommendation 5: "Better risk differentiation in regulatory capital requirements." The criteria for assessing lending risk should therefore reflect the actual commercial risks. Consequently, any forced consideration or weighting of factors beyond that justified by the actual commercial risks should be avoided.

- **An overly mechanistic/prescriptive regulatory approach creates an undesirable divergence between regulatory and economic risk assessments.** In response to **Question 2**: Option 1, which mechanically determines a minimum level of risk by reference to factors which may not be commercially relevant, is unattractive for this reason. Option 2, which places a minimum weighting of 10% upon any one factor, is preferable to Option 1 (but is still not ideal), since the level of distortion required in the assessment of risk is reduced. Clearly it would be preferable to have a minimum weighting of less than 10% to maximise the extent to which capital requirements reflect actual commercial risk.

- **Unnecessarily high regulatory burdens carry economic costs.** Regulators have an important role to protect financial stability, however the reduced economic growth which results from excessive regulation and excessive regulatory capital requirements means it is also important to ensure that regulation and capital requirements are genuinely necessary. Option 1, and Option 2 with an unduly high minimum weighting, would potentially restrain economic growth beyond that required to protect financial stability.

- **Consistency of regulatory approach is best achieved by a combination of national market expertise and understanding coupled with international oversight and encouragement.** In considering how prescriptive the RTS should be, it appears that the challenge is seen as being how to balance (a) the benefit of national regulators and those they supervise being able to exercise judgement on risk in light of their more informed understanding of their national market, against (b) the advantages of standardising the approach across member states with the potential for a less accurate assessment

of actual risk given different market structures. Perhaps a better option would be to allow national regulators to exercise judgement in determining how lending risk is assessed, but overlay that with limited international oversight which compares national approaches and encourages consistency, with a view to migrating to an optimal consistent assessment of risks under an approach which reflects national market structures.

- **IPRE lending only threatens financial stability when there is a market correction.** In practice, financial stability is only threatened by real estate lending when lenders experience substantial losses on that lending, which generally only occurs following a significant decline in real estate market values, i.e. following a real estate correction or crash. The assessment of potential losses arising from real estate lending should therefore be considered in light of an anticipated level of market correction, rather than either (a) historical losses which have arisen during periods when no correction has occurred; or (b) by assuming a static level of potential market correction irrespective of the position which the real estate market is at in its cycle.

- **Regulatory capital rules need to be counter-cyclical, and using loan to long-term value as a criterion is the best way of achieving that.** The single largest challenge which the proposals should address is the pro-cyclicality of the capital requirements regime, as this was arguably a significant factor in relation to commercial real estate lending during the Great Financial Crisis. At the root of this is that the rise in market values which occurs during boom years deceives the assessment of risk. An increase in market values reduces loan-to-value ratios, giving the perception of reduced risk. To address this critical issue, the Vision Report made Recommendation 4: "Use of long-term value measures for risk management," which proposed that "loan-to-value based capital requirements should be linked to a long-term measure of collateral value that is insensitive to the investment cycle." In response to **Question 6**, we consequently suggest that loan to long-term value, as described in the Vision Report, should be one of the main assessment criteria for real estate.

- **Effective regulation must be based on robust, comparable and timely data, especially for so specialised and complex a market as IPRE.** The real estate market, unlike most financial markets, is both idiosyncratic and opaque. Regulators, lenders and others have struggled just to know what is happening in the market and consequently proved to be poor at assessing the levels of risk arising from real estate lending. While regulators and lenders have made some progress in their understanding of IPRE lending, the arrival of new lenders in the market who are not subject to regulatory supervision in the same way as the banks means there remains limited overall up to date understanding of IPRE lending. The Vision Report suggested, in its Recommendation 1: "Loan database", that all lenders in the commercial real estate market "should be required to collect and submit to a centralised database specified information about each […] CRE loan and its collateral, immediately upon making the loan and periodically throughout its life." Only once regulators have a full, up to date, knowledge and understanding of the commercial real estate lending market can they confidently keep regulation to an effective minimum and thereby protect financial stability while (within that constraint) maximising economic growth. If national CRE loan databases were in place, evidence-based regulatory supervision would be more effective both nationally and when comparing approaches adopted by different national regulators.

- **Question 6:** We have supported industry comments which have already been made to the EBA in relation to the assessment criteria. In general the following points are highlighted:

    - Whether an assessment criterion is improving or worsening is less relevant than the current actual assessment. Examples are: (A) the fact that a property's DSCR or ICR has deteriorated, does not necessarily mean that they are at a level which causes significant concern. (B) the fact that the value of a property has fallen, does not mean that the loan is not covered by the value of the security.
    - We would suggest replacing references to "loan to value" with "loan to long-term value".

If you have any questions in relation to these comments or the Vision Report please contact Nicholas Scarles, Group Finance Director, Grosvenor Group Limited.

Yours faithfully

Grosvenor Group Limited
11 August 2015