BPF

BRITISH PROPERTY FEDERATION

Consultation Paper on draft EBA guidelines on limits on exposures to shadow banking entities – a response from the British Property Federation

Introduction

The British Property Federation (BPF) is the voice of property in the UK, representing businesses owning, managing and investing in property. This includes a broad range of businesses comprising commercial property developers and owners, financial institutions, corporate and local private landlords and those professions that support the industry.

We welcome the opportunity to comment on the European Banking Authority's (EBA's) draft guidelines on limits on exposures to shadow banking entities.

Executive summary

We agree that it may be appropriate to impose limits on exposures to shadow banking entities that carry out bank-like activities involving maturity transformation, leverage, credit risk transfer or similar activities outside a regulated framework. However, the approach proposed by the EBA goes much further than that, and cannot be supported.

In particular, we believe that the approach adopted in the consultation paper in relation to UCITS funds – namely that they should be excluded from scope unless they are MMFs – should also be adopted in relation to AIFs. The EBA's failure to apply similar principles in relation to UCITS funds and AIFs is not explained or justified, and would be both distortive and prejudicial to Europe's financial services industry and the real economy.

In the absence of a definition in the CRR of the terms 'shadow banking entities', 'banking activities' and 'regulated framework', the EBA is right to define shadow banking entities for the purposes of the Guidelines. However, the proposed definition is far too broad in its scope and would capture a large proportion of the asset management industry that is clearly not part of the credit intermediation process other than as end-users.

We are particularly concerned that the EBA appears to be taking a different approach to defining 'shadow banking entities' than the Financial Stability Board (FSB), which has reasonably concluded that equity real estate investment funds (among others) should not be included in any measures of the size of the shadow banking sector. We would urge EBA to do the same.

Real estate funds are not part of the credit intermediation process

The total universe of AIFs is very diverse, including among other entities:

- hedge funds, private equity funds, venture capital funds and different kinds of real estate funds;
- closed-ended funds and open-ended funds;
- funds that are highly leveraged, modestly leveraged and unleveraged; and
- funds that invest in real assets, different kinds of operating businesses, and financial instruments, which may (or may not) include loans or other credit exposures.

It is surprising, given the extensive work already carried out by the FSB and others in relation to shadow banking, that the EBA has failed to discriminate in any way, proposing instead to shoehorn all AIFs, regardless of their characteristics, into its shadow banking definition. No doubt some AIFs engage in maturity and liquidity transformation, are outside the traditional banking sector and are not subject to an appropriate regulatory framework; but many AIFs, and certainly most real estate AIFs, do not.

Real estate equity funds

Helpfully, the FSB's Global Shadow Banking Monitoring Report 2014 has a section specifically discussing real estate funds. It notes that most real estate funds invest in and own physical properties so that their revenues are derived directly from rental income, while some others invest in debt, deriving most of their income from real estate loans.

The FSB notes that real estate funds that invest in and own physical properties are "typically not part of the credit intermediation process, as they neither lend directly to other financial entities nor do they hold fixed income products in any significant way in their investment portfolio". These funds are generally AIFs: they typically carry on some or all of the development, acquisition, maintenance and management of land and buildings that are rented out to businesses or other users. However, in almost all cases, they are not part of the credit intermediation process.

The EBA should reconsider its view, or at the very least set out its reasoning and identify the principles whose applications to funds should determine which AIFs, in particular, should be treated as shadow banking entities. The EBA has only explained its proposed inclusion of MMFs (which appears sensible, although we express no opinion as MMFs fall outside our area of expertise).

The EBA has also adopted contradictory approaches to UCITS funds and AIFs without adequate explanation. Such an approach will create arbitrary differences between EU definitions and those emerging at the global level, and will not serve the EU's economy or financial system.

Real estate debt funds

Real estate debt funds warrant separate discussion as they could legitimately be considered part of the credit intermediation process.

Most real estate debt funds in Europe are closed-ended, and use either no, or modest levels, of leverage themselves. Their similarity to banks begins and ends with their provision of credit to the real economy. They do not carry out maturity or liquidity transformation, they are not generally

exposed to run risks, banking system interconnectedness issues do not arise, and they could, of course, be allowed to fail. Furthermore, the AIFMD provides a robust and adequate regulatory framework for them which significantly limits the risks they might be seen to pose.

These funds play an essential role in helping Europe's banks to repair their balance sheets and addressing the pre-crisis legacy of over-leveraged real estate across Europe, while also providing alternative sources of credit for real estate businesses. If there are real estate debt funds that are open-ended and highly leveraged, as is more usual in the US, for example, the EBA may well have a case for classifying them as shadow banking entities, despite the regulatory framework provided by the AIFMD. However, this extremely small group of funds does not justify including all real estate AIFs within the definition of shadow banking activities.

It may be that there are other types of fund within the diverse universe of AIFs that would similarly warrant classification as shadow banking entities (such as hedge funds; however, we express no opinion on this issue as hedge funds fall outside our area of expertise). But the EBA's broad-brush, arbitrary and inconsistent approach in relation to (non-MMF) AIFs cannot in our view be justified. The EU should also be very wary of taking an approach that so conspicuously diverges from the far more reasoned and evidence-based approach taken by the FSB at the global level.

We would be pleased to help the EBA better understand the real estate funds and the real estate debt funds that form part of the AIF universe so that it can develop a more appropriate proposal than that contained in the Consultation Paper. The implications of including all real estate funds in the definition of shadow banking activities in terms of potentially reduced flows of capital to this vitally important economic sector would be immeasurable and easily avoidable.

AIFMD is a sufficiently robust prudential framework

We are surprised at the consultation paper's approach to determining what entities are not subject to "an appropriate and sufficiently robust prudential framework" under the second limb of the definition of shadow banking entities. It is a gross slight to the efforts of the European Parliament, European Commission, European Securities Markets Authority and national financial regulators of the EU Members States to so casually determine that the Alternative Investment Fund Managers Directive, which is now fully in effect and covers the vast majority of real estate and other alternative investment funds, is not "an appropriate and sufficiently robust prudential framework".

The consultation paper specifically cites the EU UCITS directive (Directive 2009/65/EC) and states that it prescribes a robust set of requirements under which undertakings for collective investment in transferable securities, and their managers, operate. These are noted to include "requirements on the asset manager (initial capital, own funds and internal control requirements) and the managed funds (e.g. limits to leverage and concentration). Therefore, such funds do not pose the same level of risk to institutions in terms of credit and step-in/bail-out risk (e.g. due to reputational, franchise and other risks) as unregulated funds".

As a result, UCITS funds (other than MMFs, which are dealt with differently for specific reasons) are specifically excluded from the proposed scope of coverage of the Shadow Banking Guidelines. We agree with both the consultation paper's reasoning and conclusion in this regard. However, we do not understand why the same approach is not adopted in relation to alternative investment funds and the AIFMD.

UCITS served as the model for AIFMD. Like UCITS funds, real estate and other AIFs within the scope of AIFMD have requirements on the asset manager including initial capital, own funds and internal control and reporting requirements, and AIFs themselves are subject to requirements related to leverage. Like UCITS funds, real estate AIFs do not pose the same level of risk to institutions in terms of credit and step-in/bail-out risk (e.g. due to reputational, franchise and other risks) as unregulated funds. Like UCITS funds, real estate AIFs within the scope of AIFMD (other than MMFs) should be specifically excluded from the proposed scope of coverage of the Shadow Banking Guidelines.

It is important to remember that the term "AIF" is not limited to funds managed by an AIFM that is registered or authorised under the AIFMD. Accordingly, we comment on two specific categories of AIF that are not subject to the full AIFMD regime.

- Sub-threshold AIFMs and the correspondingly small AIFs they manage are specifically excluded from the scope of coverage of the AIFMD. Their exclusion is justified by the modest level of risk they pose and the disproportionate burden that full AIFMD compliance would represent for such small entities. The same logic dictates that they should also be exempted from the scope of coverage of the EBA's Shadow Banking Guidelines.
- AIFs whose manager falls outside the scope of the AIFMD because of its territorial limitations should in our view also fall outside the scope of the EBA's Shadow Banking Guidelines. Given that the connection of such AIFs to the EU is insufficient to justify regulation under the AIFMD, the EBA would need to make a clear case for defining them as shadow banking entities. The EBA has not done that.

We remain at your disposal should you wish to discuss the above in more detail.

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