Response to consultation on macroprudential policies for non-bank financial intermediation (NBFI)

INREV

14 November 2024

To: DG Financial Stability, Financial Services and Capital Markets Union, European Commission

Response to the Targeted Consultation Document Assessing the Adequacy of Macroprudential Policies for Non-Bank Financial Intermediation (NBFI)

1. Key vulnerabilities and risks stemming from NBFI

Q1 Are there other sources of systemic risks or vulnerabilities stemming from NBFIs' activities and their interconnectedness, including activity through capital markets, that have not been identified in this paper?

The European Association for Investors in Non-Listed Real Estate Vehicles (INREV) submits the following comments from our perspective as a non-profit industry association that provides guidance, research and information related to the development and harmonisation of professional standards, reporting guidelines and corporate governance within the non-listed property funds industry across Europe.

INREV currently has more than 500 members comprised of institutional investors from around the globe including pension funds, insurance companies and sovereign wealth funds. Investment banks, investment managers, fund of funds managers and advisors representing all facets of investing in non-listed real estate vehicles in Europe are also represented in our membership. Investment structures include both equity and debt investments in funds, joint ventures, club deals and separate accounts for institutional investors, the vast majority of which are regulated under AIFMD.

Commercial real estate is capital intensive. Real estate funds typically use debt in their structures, but this can vary widely with, on one end of the scale, large ODCE funds (Open-End Diversified Core Equity) typically using little or no debt, and with much smaller opportunistic development funds using considerably more debt. INREV data show that weighted average debt in all the funds in our vehicles universe hovers around 21% calculated on a look-through basis including both fund-level and asset-level debt. This level of debt is significantly lower than is generally assumed for our intransparent sector and admittedly lower than average debt levels before the Global Financial Crisis.

While real estate cycles are a fact of life, institutional investors are keenly aware of the risks of falling real estate values. Nevertheless, as long-term investors with deep pockets, they are able to ride out downturns in the market, which are marked by fewer sales and a drop in capital values, while continuing to collect income in the form of rent. Many or even most institutional investors are also able to invest countercyclically and therefore put a floor on falling values and a ceiling on real estate bubbles. Because of their different investment horizons and liquidity profiles, institutional investors are generally unwilling to invest alongside retail investors.

Institutional investors do invest in open end funds, though, and of course eventually redeem their investments. While suspensions and deferral of redemptions do occur in real estate funds, it is

important to understand the difference between a full "suspension" and a deferral of redemptions as a feature of business-as-usual operations. Either can take place even though there is no financial crisis and, instead, when the issue is more of a practical one – such as available cash on hand at certain moments. They can also occur, for example, in situations such as during COVID, when lockdowns limited access to buildings, which made performing valuations impossible. This resulted in a situation where neither a sales price nor a redemption price could be calculated that would be fair to both the exiting and remaining investors and redemptions were suspended until there was more pricing certainty.

As an illiquid asset class, real estate funds for institutional investors do not generally provide the daily liquidity, the suspension of which is a concern of regulations addressing systemic risk. Most commonly, dealing days for subscriptions and redemptions for institutional funds are quarterly, with two or more quarters to meet redemptions. Redemptions not met in a quarter are deferred until the subsequent quarter. Some real estate funds have significantly less frequent redemption dates. There are examples of OEFs for institutional investors with liquidity points every fifth year.

Q2 What are the most significant risks for credit institutions stemming from their exposures to NBFIs that you are currently observing? Please provide concrete examples.

We do not observe significant risks for credit institutions stemming from their exposures to NBFIs in the CRE finance market. We believe that financial stability would be improved by a greater shift in CRE financing from banks to NBFIs.

Q4 Where in the NBFI sectors could systemic liquidity risk most likely materialise and how? Which specific transmission channels of liquidity risk would be most relevant for NBFI? Please provide concrete examples.

The kind of liquidity mismatches that the consultation paper focuses on that we are best able to address relate to open end funds (OEFs) that invest in real estate, which is an inherently illiquid asset class. As we noted in response to Q1, while real estate cycles are a fact of life, institutional investors are keenly aware of the risks of falling real estate values. Nevertheless, as long-term investors with deep pockets, they are able to ride out downturns in the market, which are marked by fewer sales and a drop in capital values, while continuing to collect income in the form of rent. Many or even most institutional investors are also able to invest countercyclically and therefore put a floor on falling values and a ceiling on real estate bubbles. Because of their different investment horizons and liquidity profiles, institutional investors are generally unwilling to invest alongside retail investors.

Institutional investors do invest in open end real estate funds, though, and of course eventually redeem their investments. While suspensions and deferral of redemptions do occur in real estate funds, it is important to understand the difference between a full "suspension" and a deferral of redemptions as a feature of business-as-usual operations. Either can take place even though there is no financial crisis and, instead, when the issue is more of a practical one – such as available cash on hand at certain moments. They can also occur, for example, in situations such as during COVID, when lockdowns limited access to buildings, which made performing valuations impossible. This resulted in a situation where neither a sales price nor a redemption price could be calculated that would be fair to both the exiting and remaining investors and redemptions were suspended until there was more pricing certainty.

As an illiquid asset class, real estate funds for institutional investors do not generally provide daily liquidity, the suspension of which is a concern of regulations addressing systemic risk. Most commonly, dealing days for subscriptions and redemptions for institutional funds are quarterly, with two or more quarters to meet redemptions. Redemptions not met in a quarter are deferred until the subsequent quarter. Some real estate funds have significantly less frequent redemption dates. There are examples of OEFs for institutional investors with liquidity points every fifth year. INREV has developed Liquidity Guidelines comprised of principles and guidance that are based on commonly accepted industry best practices and are widely adhered to (see here).

Furthermore, as we noted in Q1, it is important to note that while real estate funds typically use debt in their structures, this can vary widely with, on one end of the scale, large ODCE funds (Open-End Diversified Core Equity) typically using little or no debt, and with much smaller opportunistic development funds using considerably more debt. INREV data show that weighted average debt in all the funds in our vehicles universe hovers around 21% calculated on a look-through basis including both fund-level and asset-level debt. This level of debt is significantly lower than is generally assumed for our intransparent sector and admittedly lower than average debt levels before the Global Financial Crisis.

Q5 Where in the NBFI sectors do you see build-up of excessive leverage, and why? Which NBFIs could be most vulnerable? Please provide concrete examples.

While there are no doubt pockets of excessive leverage in CRE markets, we are not aware of any structurally significant build-up of excessive leverage other than perhaps in certain banking markets.

Q7 Considering the role NBFIs have in providing greater access to finance for companies and in the context of the capital markets union project, how can macroprudential policies support NBFIs' ability to provide such funding opportunities to companies, in particular through capital markets? Please provide concrete examples.

The emergence of NBFIs as providers of debt to CRE, including non-listed real estate loan originating funds, has made it easier for banks wishing to reduce their exposure to the CRE sector and allows the CRE sector continued access to debt, while also providing a reasonable source of risk-adjusted returns for institutional capital. Diversifying CRE debt sources beyond banks is beneficial, as it reduces the risk of concentrated exposure within the banking system. Indeed, a diverse lending market, with various regulatory incentives and risk preferences, enhances the stability and resilience of CRE finance by mitigating synchronised responses to economic or regulatory shifts.

The EU CRE debt market faces challenges in reducing banks' exposure to CRE risk and fostering alternative sources of debt. While Basel III finalisation could lower banks' risk appetite for CRE lending, this shift will only help if other capital sources can step in. However, the absence of a fully realised Capital Markets Union (CMU) and the presence of regulatory, tax, and legal barriers across EU member states hinder the growth of non-bank debt alternatives.

A scaled CMBS market could enable banks to distribute CRE risk more broadly, while a CRE-CLO market would support the financing of construction projects, retrofitting, and upgrades for energy efficiency. Meanwhile, ESMA's current disclosure requirements are very widely reported to produce no

useful disclosures for CRE debt securitisation investors, who instead rely on loan servicer investor reporting and data and analysis provided by third party industry specialists.

Q16 How can NCAs better monitor the liquidity profile of OEFs, including redemption frequency and LMTs, in order to detect unmitigated liquidity mismatches during the lifetime of OEFs?

Investment Managers and Institutional Investors must report on the LMTs that they have agreed upon for real estate investment funds at the inception of these funds. Alongside this, it is essential to report the redemption frequencies that have also been established between these parties at the fund inception.

For real estate funds catering to Liability Driven Investors, it should be required to disclose information regarding other assets within their portfolios that may be utilised for liquidity buffers, such as listed real estate, bonds, equities and cash. Furthermore, NCAs should be aware that there is an increasingly active secondary market for participations in non-listed real estate funds, which can provide liquidity to investors at all times, including during periods when LMTs are activated and redemptions are suspended, gates imposed, etc.

It is also important to understand that not all open-ended real estate funds face liquidity mismatch issues. These funds generally align subscription and redemption timing with the liquidity of their underlying assets, which is rarely daily. Many of the long-term funds investing in real estate (including housing and regeneration) are evergreen vehicles that do not offer the short-term liquidity but nevertheless fall within the AIFMD definition of an OEF by providing redemption rights within the first five years of the life of the fund. This is equally true of many funds investing in infrastructure.

As we noted in Q1 and Q4, while suspensions and deferral of redemptions do occur in real estate funds, it is important to understand the difference between a full “suspension” and a deferral of redemptions as a feature of business-as-usual operations. Either can take place even though there is no financial crisis, and instead when the issue is more of a practical one – such as available cash on hand at certain moments. They can also occur, for example, in situations such as during COVID, when lockdowns limited access to buildings, which made performing valuations impossible. This resulted in a situation where neither a sales price nor a redemption price could be calculated that would be fair to both the exiting and remaining investors and redemptions were suspended until there was more pricing certainty.

As an illiquid asset class, real estate funds for institutional investors do not generally provide daily liquidity, the suspension of which is a concern of regulations addressing systemic risk. Most commonly, dealing days for subscriptions and redemptions for institutional investors are quarterly, with two or more quarters to meet redemptions. Redemptions not met in a quarter are deferred until the subsequent quarter. Some real estate funds have significantly less frequent redemption dates. There are examples of OEFs for institutional investors with liquidity points every fifth year.

Q48 Do stakeholders have views on macroprudential tools to deal with leverage of NBFIs that are not currently included in EU legislation?

Addressing the leverage of NBFIs might not be always necessary. While leverage can indeed pose systemic risk implications, particularly within CRE finance markets, these implications primarily arise

from the often cyclically excessive leverage extended by banks. It is not unequivocally evident that leverage within the real estate sector is inherently problematic, nor that the leverage provided by NBFIs poses significant concerns.

2. Monitoring interconnectedness

Q52 Do you have concrete examples of links between banks and NBFIs, or between different NBFI sectors that could pose a risk to the financial system?

As far as the CRE debt market is concerned, the participation of NBFIs as lenders or debt investors generally serves to reduce risk which is otherwise traditionally concentrated in the European banking sector.

Q54 Is there a need for arrangements between NBFI supervisors and bank supervisors to ensure timely and comprehensive sharing of data for the conduct of an EU-wide financial system stress tests?

We encourage additional collaboration between supervisors and financial regulators who operate in different sectors, such as those focused on securitisation, insurance, banking, and investment funds. It's also important for financial regulators to engage with other policymakers to ensure, for example, alignment on decarbonisation goals at both the government and Commission levels, as well as to coordinate approaches to climate risk and opportunities among banking regulators.

Q57 How can we ensure a more coordinated and effective macroprudential supervision of NBFIs and markets? How could the role of EU bodies (including ESAs, ESRB, ESAs Joint Committee) be enhanced, if at all? Please explain.

The most important first step would be to adopt EC/ECB proposal regarding real estate data gathering and sharing among NCAs. In the INREV response to the European Commission consultation on Commercial Real Estate data in January 2024, we note that we strongly support the Commission's Call for Evidence on Commercial Real Estate Statistics. Indeed, we believe that the collection and analysis of high-quality commercial real estate data is essential for informed decision-making by policy makers, investors and researchers.

Currently, we witness a significant lack of high-quality and consistent commercial real estate data available to policy makers in Europe. As a result, this data gap makes it difficult for policy makers to monitor and regulate the commercial real estate market effectively, and for investors without access to privately held data to make informed decisions about real estate investments. This is because publicly available data is often fragmented, inconsistent and not up-to-date. We can relate this to a number of factors, including:

- the lack of a common set of definitions for commercial real estate data across European countries,
- the reliance on voluntary data collection from real estate firms,
- the need for a European Commercial Real Estate Statistics Regulation.

To address the current data gap in commercial real estate in Europe, we therefore recommend the following measures:

Initiation of Regulation

INREV recommends that the European Commission take the lead in initiating and adopting a regulatory framework to serve as a cornerstone for the systematic collection and analysis of commercial real estate data across Europe.

Data Collection Mandate

We also suggest that the regulatory framework mandates Member States to actively collect and report data on key commercial real estate metrics. These metrics would encompass crucial factors such as prices, rents, vacancy rates, and construction starts.

Consistency and Standardisation

INREV suggests that the regulatory framework ensures a consistent approach to data collection. This would include adherence to common definitions and standards and would foster reliability and comparability across different jurisdictions.

We believe that a European Commercial Real Estate Statistics Regulation would have a number of benefits, including:

- Improved transparency and accountability in the commercial real estate market.
- Enhanced ability for policy makers to monitor and regulate the market effectively.
- Increased access to high-quality data for investors, making it easier to make informed decisions.
- Strengthened research capacity in the commercial real estate sector.

INREV recommends a thoughtful consideration of regulatory measures to address the data gap in commercial real estate in Europe before follow-on steps are taken in the regulation of NBFIs. We believe that a collaborative and consultative approach could lead to the development of a regulation that not only meets the needs of various stakeholders but also contributes significantly to the stability and growth of the European economy. We remain available to work with the European Commission and Member States to develop and implement a successful commercial real estate statistics regulation.