

Subject: INREV's response to EBA's "Draft Guidelines on limits on exposures to shadow banking entities which carry out banking activities outside a regulated framework under Article 395 para. 2 Regulation (EU) No. 575/2013".

Date: 18 June 2015

Dear European Banking Authority,

Please find attached INREV's response to EBA's "Draft Guidelines on limits on exposures to shadow banking entities which carry out banking activities outside a regulated framework under Article 395 para. 2 Regulation (EU) No. 575/2013", 19 March 2015 – 19 May 2015.

We hope again to provide a meaningful contribution to your work to support the development of a sound regulatory framework and remain available should you have any specific questions about the non-listed real estate fund industry.

Kind regards,



Matthias Thomas
Chief Executive INREV

Attachment:

INREV response to EBA's "Draft Guidelines on limits on exposures to shadow banking entities which carry out banking activities outside a regulated framework under Article 395 para. 2 Regulation (EU) No. 575/2013", 19 March 2015 – 19 June 2015.

About INREV: the voice of the European non-listed real estate investment industry

INREV is the European Association for Investors in Non-Listed Real Estate Vehicles. We provide 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 370 members. Our member base includes institutional investors from around the globe including pension funds, insurance companies and sovereign wealth funds, as well as investment banks, fund managers, fund of funds managers and advisors representing all facets of investing into non-listed real estate vehicles in Europe.

Our fund manager members manage more than 500 European non-listed real estate investment funds, as well as joint ventures, club deals and separate accounts for institutional investors. INREV's members represent almost all jurisdictions of the European Union's internal market and a range of underlying long-term investment vehicle structures, both CIVs and other non-listed real estate investment vehicles, the vast majority of which are Alternative Investment Funds ("AIFs") subject to regulation under the European Alternative Investment Fund Directive ("AIFMD").

Comments regarding the EBA Consultation Paper

INREV agrees that it may be appropriate to impose limits on exposures to shadow banking entities which 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. The decision to include in the definition entities that: a) are carrying out credit intermediation activities, defined as bank-like activities involving maturity transformation, liquidity transformation, leverage, credit risk transfer or similar activities; and b) are not within the scope of prudential consolidation nor subject to solo prudential requirements under specified EU legislation (or equivalent third country legal frameworks), in the first instance, is not objectionable.

AIFMD is a sufficiently robust prudential framework

Where INREV specifically disagrees with the consultation paper approach is its determination of 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.

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 Financial Stability Board 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.

Non-listed 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 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.

Non-listed 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 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 funds 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.