ZIA Zentraler Immobilien Ausschuss e.V. · Wallstraße 16 · 10179 Berlin

Secretariat to the
Financial Stability Board
c/o Bank for International Settlements
CH-4002 Basel
SWITZERLAND

fsb@bis.org

Berlin, April 7th, 2014

Dear Madam / Sir,

ZIA response to Financial Stability Board (FSB) consultation on Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically important Financial Institutions

The German Property Federation (ZIA) is one of the major interest groups of the German real estate industry. We consider ourselves to be the voice of Germany's real estate industry, speaking for numerous most notable companies of the real estate industry as well as 22 associations, together representing more than 37,000 members. ZIA's main goal is to act as a comprehensive and homogenous lobby for the diverse real estate industry in line with its vital importance for the German economy. As a union of businesses and associations, ZIA enables the whole real estate industry to speak with one voice on a national and European level – as well as within the Federation of German Industries (BDI).

ZIA welcomes the opportunity to respond to the consultation on *Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically important Financial Institutions*. The real estate industry is interested in contributing to the work on how to handle systemic risks on the global level. The financial crises of the past have taught that the economic and financial system is dependent on the abundance of collateral provided by the real estate industry. The availability of collateral is crucial for the functioning of the modem financial system. The well-being of the real estate industry thus is of utmost importance to the world economy. ZIA represents the German property market, which is the largest in Europe and is – on a global scale – only surpassed by the markets of the US and Japan.

Our ongoing concern with many regulatory activities is the poor understanding of the economic function of the real estate industry. Particularly, the real estate industry is an industry that is dependent on the availability of capital. Especially in those parts of the industry where profit is low, the industry is also very sensitive to deteriorations of the capital supply, even when such deterioration is minor in scale. We feel that the regulatory approaches to correct the financial sys-

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Prof. Dr. Matthias Thomas
Dirk Töngcs
Peter Tzeschlock
Dr. Hans Volkert Volckens
Dr. Marc Weinstock
Claus Wisser

Geschäftsführer:
Axel von Goldbeck
Klaus-Peter Hesse

Zentraler Immobilien Ausschuss e.V.
German Property Federation
Wallstraße 16, 10179 Berlin
T. +49 (0) 30 - 20 21 585 - 0
F. +49 (0) 30 - 20 21 585 - 29
info@zia-deutschland.de
www.zia-deutschland.de

Büro Brüssel:
Rue du Commerce 31
B-1000 Bruxelles
Telefon: +32 (0) 2 - 792 10 05
Telefax: +32 (0) 2 - 25 48 90 29

VR 25863 B (Berlin-Charlottenburg)

tem in recent years frequently failed to recognize the interests of the real estate industry.

This is very unfortunate because of (1) the strong connection between the crucial function of the real estate industry for the functioning of modern capital markets and the financial system generally and (2) the contributions of the industry to the overall well being of society. For many regulators, it seems that real estate and its availability is a given, maybe because the industry seems to lack appeal due to its long-term nature. This, however, is a view that is not in line with the sophisticated nature of modern real estate financing and the diverse types of funding of real estate investments contemporarily used.

Q1-1. In your view, are the three transmission channels identified above most likely to be the ones transmitting financial distress of an NBNI financial entity to other financial firms and markets? Are there additional channels that need to be considered?

First, we side with the FSB with regard to its analysis of the importance of critical functions (1.3). The inability or unwillingness of an NBNI financial entity to provide critical functions or services can be a severe hit to the functioning of the financial system. There would be much value in a closer look at entities that provide such critical functions or services. Often when there is no ready substitute for the services of a market participant, the reason for this may be found in a lack of competition. Thus, it might be well worth to investigate the reasons for such lack of competition. Generally, it cannot be ruled out there might be involved some legal or factual monopoly, or cartelization, of a critical market function. ZIA would welcome if further thought would be invested in this matter to clarify under which circumstances market participants could gain so much market power that they do not have to deal with competitors. Under normal market conditions competitors would be willing and able to quickly assume any business the market leader leaves on the table.

Second, we are much more cautious with regard to the FSB's analysis of both the counterparty channel (1.1.) and the market channel (1.2). The key issue with the market channel is that forced liquidations could lead to a depressed price of such asset. However, this is nothing unusual. Any (fire-)sale of an asset shows an increased supply of an asset. Increased supply leads, ceteris paribus, to lower prices – for all market participants, even those not involved in a particular transaction. This is the very nature of the market process. Moreover, such change in prices provides most valuable signals to these other market participants. The price system so works as a tool to disperse private knowledge among any and all market participants. Therefore, identifying the market channel as a transmission mechanism seems to be trivial and probably adds no additional analytical value.

However, we would welcome much more the FSB's other insight, which it spells out under the headline of the market channel, namely the FSB's recognition that forced liquidations "may be amplified by the use of leverage by financial entities". Therefore, it is not the market channel that creates distortions but the inappropriate risk-taking of certain market participants, which disrupts the regular

process of forced liquidations. In other words: No one loves the messenger who brings bad news. But do not shoot him. Bad news is better than no news, or falsified news, for that matter. Thus, the FSB should turn to the activities that endanger the winding down of an investment, e.g. "amplified [...] use of leverage", instead of the market channel that merely transmits such information to other market participants.

Should the FSB consider providing more depth to its analysis with regard to the possible amplification of risks due to the use of leverage, we would like to bring the very specific nature of real estate markets into focus. Leverage is generally limited and forced liquidations take their time. Moreover, the real estate market and its players are generally already subject to regulatory authorities.

We would come to a similar conclusion with regard to the counterparty channel. Similarly to the market channel, the counterparty channel (1.1) seems to be no more than a series of contractual relationships. If so, there would be no analytical value at all in recognizing that creditors are affected when their debtor goes bankrupt. This is common knowledge and the very risk any creditor must assume if he wants to be creditor. Again, the actual insight is that the assumption of credit risk could lead "to broader financial instability if [...] exposures and linkages are significant." The key to the understanding of systemic risks and transmissions mechanism lies not with the (counterparty) channel itself but with the very individual risks of market participants, which in such cases are due to significant "exposures and linkages". ZIA would suggest finding out more about the circumstances under which these risks could realize in a cascading manner. It could be probable that the instability of the financial system could be brought about when (1) the risks that market participants assume are very much alike, and (2) when market participants do not sufficiently diversify their asset structure. If this were so, thinking about the counterparty channel seems to be the wrong way to go. Rather, better risk management should be stressed.

With regard to the German market, we would like to point out that it acts as a role model: German real estate is financed most conservatively. Especially, loans with variable interest are used rarely, effectively bringing the time horizons of financing and investing in line. This helps to keep risks stemming from credit intermediation in check. Hence, the German Bundesbank, which screens the German real estate market closely for any signs of frothiness, does not see asset bubbles in real estate, which were so common in much of the rest of Europe.

Q2-1. Does the high-level framework for identifying NBNI G-SIFIs (including the five basic impact factors) adequately capture how failure of NBNI financial entities could cause significant disruption to the wider financial system and economic activity? Are there any other impact factors that should be considered in addition to those currently proposed or should any of them be removed? If so, why?

ZIA very much agrees that it is indeed challenging to develop methodologies that allow sufficient flexibility to capture different risks that lead to disruption within the financial system. More work needs to be done to overcome the challenge posed by diverse business models of financial entities. The FSB tries to

accomplish this goal by introducing a basic set of impact factors to be applied to all NBNI financial entities in general. This basic set of impact factors consists of size, interconnectedness, substitutability, complexity, and cross-jurisdictional activities. While we think this set could be successfully utilized, we miss the risk of certain activities or inherent to business models among these impact factors.

The FSB has preferred to treat risk in various forms as an indicator. However, we would rather have risk as a criterion among the impact factors. Therefore, we would strongly suggest moving risk one level higher, from indicators to the basic set of impact factors. Risk, in our opinion, plays so huge a role that it cannot be underestimated as a factor. Then, risk as an impact factor should be fanned out by indicators which are suitable to identify risk in its various and diverse appearances. Our approach would, so we think, much better weed out non-risky businesses from the scope of regulation. The approach of the FSB would instead lead to a wide umbrella and leave it to national regulators to limit oversight and thus give room to regulatory arbitrage. To sum up, we would advise to add risk to the list of impact factors.

On a side note, we would like to underline the FSB's skeptical outlook concerning the availability of data. Obtaining appropriate data, especially consistent data across jurisdictions, is (a) a huge challenge, and (b) a prerequisite to regulation. More harm than good could be done if regulation of certain activities was asked to be implemented prematurely. Premature implementation would be comparable to a shot in the dark. Sometimes shooting in the dark leads to horrible accidents.

For example, the contents of Solvency II resemble, with regard to the German market, a shot in the dark, which has led to unintended regulatory effects. The European Commission acted on data that were collected in the British market. However, even within the EU real estate markets are not necessarily alike. In more detail, due to institutional reasons British real estate financing tends to be more risky than German real estate financing. The EC generalized their data about risk in the British market and set their rules accordingly. Now Solvency II asks insurers across Europe to work with the same shockfactor. We would concede that the shockfactor might be chosen well with regard to the risk inherent to British real estate financing, but it would be too high with regard to the lower risk inherent to German real estate. Effectively, the German real estate market is now at a disadvantage compared to British real estate, because while (regulatory) costs are equal, the higher risk in British markets correlates with higher profits than in Germany. Therefore, the British market would, ceteris paribus, attract more capital than the German market. This could even lead to overinvesting in such riskier markets or any other market with higher returns, which in turn would make those markets more prone to frothiness.

Q3-2. In your view, are the above proposed materiality thresholds (including the level) for the NBNI financial entity types appropriate for providing an initial filter of the NBNI financial universe and limiting the pool of firms for which more detailed data will be collected and to which the sector-specific methodology will be applied? If not, please provide alternative proposals for a more appropriate initial filter (with quantitative data to back-up such proposals).

Again, we would advise to include risk as a factor. Looking behind the facade, this is what the FSB has implicitly been doing with regard to the different phenotypes of funds. For "normal" funds the threshold is set at USD 100 billion, while for "hedge funds" the threshold is set at USD 400-600 billion in GNE. The reason for this is the perceived (or assumed) difference in risks associated with these types of funds. However, just as different risk-levels lead to different thresholds for funds, the same goes for all other types of NBNI G-SIFIS. Risk as a factor should be made explicit for brokers-dealers, finance companies, funds, and other NBNI financial entities.

To be clear, risk not only has an impact on the probability of failure for a certain entity, but also determines the repercussions that a failure generates within the financial system as a whole.

Also, we would like to point out that the delineation of "normal" funds to hedge-funds strikes us as difficult. In light of recent regulatory action, we strongly suggest that problems of scope should be avoided. A recent example of unwanted fuzziness of regulatory scope concerns the AIFM-Directive. Originally aimed at hedge-funds, the lawmakers encountered difficulties in defining an AIF. This led to the rather peculiar result, that local housing companies may have been deemed an AIF. Hence, we would like to ask for clear definitions that enable an easy determination of scope.

Q3-5. Do you think that it would be beneficial to set additional materiality thresholds based on "global activity"? If so, please explain the possible indicator and the level on which materiality thresholds should be set (with reasons for selecting such indicator, the level and any practical challenges).

Missing data should not be decisive for setting the proper materiality thresholds. If the FSB is of the opinion that some data on cross-jurisdictional activities is important but missing, the criterion should not be waived just because there is no data. We would suggest collecting the data first and reexamine the question later; that is, after the appropriate data has been collected. We would ask that regulatory action in light of knowingly insufficient knowledge should be avoided.

Q6-1. In your view, does the proposed definition of investment funds provide a practical basis for applying the specific methodology (i.e. indicators) to assess the systemic importance of NBNI financial entities that fall under the definition?

Generally, we would welcome the definition and hold it to be well-suited. In order to avoid problems encountered in the recent AIFM-legislation, we would like to suggest limiting the scope so that listed companies are exempt. If broadly understood, any company listed on a stock exchange would pose practical difficulties whether it also constitutes a collective investment scheme. We would suggest avoiding such confusion, which with regard to AIFMD has generated much regulatory uncertainty over the course of a couple of years.

Q6-4. Should the methodology be designed to focus on whether particular activities or groups of activities pose systemic risks? If so, please explain the reason why and how such a methodology should be designed.

A regulatory approach to capturing systemic risks should certainly focus on whether particular activities or groups of activities pose systemic risks. It is well known that laying all your eggs in one basket usually shows to be an inferior strategy. It would be worse if many players of the same sector would employ the same strategy and ended up with taking the same risks. This would be the very definition of systemic risks. Unfortunately, we do not think there is any regulatory approach to this, because there is probably neither a methodology nor a regulatory design which could effectively recognize and handle such risks. Any regulator would have to try to be lucky. The regulatory business is retrospective business by design and, therefore, structurally cannot foresee the potential risks because of uncertainty about the future.

Rather, market structures should be preferably tested whether they are sufficiently robust and are able to generate a high capacity to absorb shocks. For example, the German market is robust due to its diversity with regard to financing, investment schemes, and vehicles used for such purposes. This provides for a multifaceted market structure with many a different kind of risk profiles and investment strategies.

Q6-5. Are the proposed indicators appropriate for assessing the relevant impact factors? If not, please provide alternative indicators and the reasons why such measures are more appropriate.

Since we suggested concentrating more on the risks associated with certain activities, with regard to size (6.3.1) we would recommend to drop AUM as a criterion and focus on GNE on a stand-alone-basis instead. If this were done, for the goal of supervision the importance of funds that are not leveraged would decrease in relation to those that are more leveraged. From a regulatory standpoint, this would stress the more risky activities.

With regard to substitutability (6.3.3) we would rather understand substitutability with regard to activities performed by the institution instead of understanding substitutability in light of the assets, or asset class, held by fund. Real estate funds are, by nature, funds with a low turnover of their assets. However, there is big competition for the assets, so that real estate funds do not perform tasks which could not be substituted. We would suggest, therefore, that the turnover of assets, especially real estate, does not designate a fund's substitutability. By nature, real estate markets differ from securities markets in that they are not as liquid and show less turnover. In terms of the trade volume in securities markets, real estate markets are always thinly traded.

A much better indicator would be a fund's congruence of financing and investing. Problems arising out of a lack of liquid markets (trading turnover) relative to the size of the AUM could be much better countered, if funds holding illiquid assets would not be pressed to engage in sell-offs once an asset goes underwater. Investors should be aware that investing in illiquid assets goes hand in hand with a long-term view of investing. In other words, a fund should not en-

gage in credit intermediation when it wants to invest in illiquid assets. Short-term financing of illiquid assets is no viable business model if the fund cannot absorb shocks to the market value of its assets. Open-ended funds, therefore, should have suitable redemption policies, which grant sufficient time for an orderly wind down or sell-off. And, indeed, there have been notable regulatory improvements with regard to redemption regimes concerning real estate investment funds.

Again, with regard to complexity 6.3.4 (indicator 4-4), the pure average does not designate the real risk. On the one hand, there surely is investor's demand for liquidity; on the other hand, however, this demand can be (and oftentimes is) restricted by contractual relationships between the fund and the investor. In other words, requests for liquidity must conform to the contractual agreement. Simply looking at the ratio is not sufficient; redemption policies have to be taken in consideration, too.

Q6-8. Is the definition of "investment strategies" sufficiently clear for assessing the "substitutability" (indicator 3-3)?

We would like to approach the matter by rephrasing the issue: on the one hand, there are many funds that share a business model and they compete with each other. When one of these funds fails, e.g. because of bad investment decisions, its competitors stand ready to absorb the business. On the other hand, there might be a single fund, which engages in a very specific business model, and which does not have any competitors in its niche. When this fund fails, there are no competitors who could pick up the failing fund's business.

This situation, we think, has nothing to do with substitutability. If only one (or even very few) funds with a niche strategy fail and there is no competition, its specific investment strategy has been shown to be a failure. Naturally, nobody would stand ready to invest in a business with a business model that has proven to be a failure. Likewise, no investor would feel the urge to adopt an investment strategy that has proven to be a failure. Therefore, the lack of potential interest in a failing entities investment strategy does not produce systemic risk. Rather, such categories of failure should be engaged under a different headline, e.g. risk, leverage, etc.

We would also like to remark, that, occasionally investment strategies of market participants seem to be alike. However, oftentimes there are market participants who use opposite investment strategies. E.g., when there are investors who expect a boom in a certain asset class, there probably are investors who expect a bust with regard to the same asset class. In times of crises, when one investment strategy fails, the opposite investment strategy proves to be correct and the market participants following the opposite strategy show interest in the declining assets of the failing investors. Opposing investment strategies effectively lead to a hedging across market participants because of their correlation. ZIA has administered an empirical study covering this topic [http://www.irebs-immobilienakademie.de/uploads/media/IREBS_Beitraege_Nr_4.pdf, Page 14 under 3.4]. Market volatility is reduced to the co-existence of different investors using different investment vehicles.

We remain at your disposal, if you should wish to discuss in more detail any of the issues raised in this letter. Please feel free to contact us.

Kind regards,

Axel v. Goldbeck

Dirk Friedrich