3 Regulation of managers and investment vehicles

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Introduction
This chapter focuses on selected tools for the regulation and supervision of managers and investment vehicles in Europe’s real estate market. It also considers Asian markets and makes some limited comparisons with Australian and US markets.

Structured as a debt or equity product and traded on a private or public market, real estate investments can be carried out in all four quadrants of the real estate investment universe. Owing to their higher trading volume, historical experience and the fact that they are open to all investors, public and equity products have been in the focus of regulators for some time. In the aftermath of the sub-prime mortgage crisis of 2007–2009, however, supervisory authorities have increased their attention to private and debt products.

In general, regulators and supervisory authorities are continually working on: 1) a sounder, more stable and secure financial system; 2) a harmonised and stringent regulatory and supervisory framework in Europe and; 3) a higher level of consumer service and protection. These regulations, however, also incur higher costs for the real estate holding or managing entities. According to the real estate industry, the process of harmonisation and thus the establishment of more and more regulations within the European Union (EU) could lead to an imbalance among the profits of a low-risk asset class, such as property. In this context, interest groups have expressed their concerns regarding the efficiency of fulfilling the original aim of various regulations as well as the short time frame as prescribed for implementation in their business process.

Rather than listing all the regulations connected with the real estate industry or all the concerns of the investment and managing industry, this chapter gives the reader a brief overview of the most recent and most relevant regulative and supervisory changes for the real estate industry in Europe.

The context of the European Union
Owing to the partial transfer of legislation to the EU, most European countries are obligated to comply with various EU regulations and directives. The European Parliament, the European Commission and the Council of the European Union aim to set a common framework for certain aspects of laws, regulations and administrative provision for the EU member states. Even if not all European countries are members of the EU, most of them at least partly follow its legal requirements to maintain access to the European single market. European politicians and economic researchers are assuming a similar course of action by the EU and the UK after the Brexit referendum on 23 June 2016 and continuing negations until the UK
B. I. Steininger et al.

is due to leave the EU on 29 March 2019. The real property market itself is naturally local but sources of investment and financing are as international as other financial submarkets. Therefore, a purely national regulation would not permit a country to reap the benefits of the European single market or the current situation on the integrated global financial market. Since the first version of the Basel Accord, international regulators have been cooperating and coordinating their prudential policies. Thus, the third version of the Basel Accord (Basel III) and the Solvency II Directive – the latter being the analogue concept for insurance companies – are the cores of the initial part of this chapter. The Mortgage Credit Directive (MCD) illustrates the direct link between the real estate industry and home owners, and the Alternative Investment Fund Managers Directive (AIFMD) and national real estate investment trust (REIT) regulations define the playing field of the important real estate investment vehicles in Europe. The following regulations therefore provide the framework for the main part of this chapter:

- Basel III (banking regulation)
- Solvency II (insurance regulation)
- MCD
- AIFMD (open- and closed-end funds)
- REIT regulation (listed investment vehicle).

The Undertakings for Collective Investment in Transferable Securities (UCITS) directive was established around 30 years ago, aiming at coordinating the differing laws of the EU member states with regard to collective investment undertakings while at the same time protecting unit-holders more effectively and in a more unified way. This was to make it easier for a collective investment undertaking to market its units in other member states of the EU and help to remove the restrictions on the units’ free circulation, thus supporting the establishment of a single capital market (European Union, 1985). Today, it represents the investment fund framework of reference in Europe. Since the UCITS directive was updated in 2014, it can be compared with the AIFMD as a parallel framework for alternative investment funds (European Union, 2014b). However, most real estate and infrastructure funds are classified as alternative investment funds and thus fall within the scope of the AIFMD. In this chapter, we focus on a detailed introduction of that directive.

Basel III in Europe

Since the late 1980s, the evolution of banking regulations has shown how different countries have cooperated in setting up rules for the financial supervision and minimum capital requirements of their banks. Since then, all Basel Accords (Basel I–III) have had a large influence on the financing decisions of private and institutional investors. Even if these regulations are not solely targeting the real estate industry, the industry does play a dominant role in the financing sector with its high investment and debt volume – on both the lending and the borrowing sides.

**General objectives**

The proposals of the Basel Committee on Banking Supervision (BCBS) with regard to Basel III and its implementing provision in the European Union – the Capital Requirements Regulation and Directive IV – were motivated by the shortcomings of the banking system’s
Regulation

To achieve the goal of increasing the stability of the financial sector, Basel III uses a ‘three pillars’ concept that was introduced in Basel II. The first pillar deals with the quantitative requirements that the minimum capital should vary with credit risk or market risk on the bank’s balance sheet. The second pillar adds qualitative aspects, such as risk strategies, supervisory processes or frameworks for dealing with different types of risk. The third pillar is concerned with market disclosure, enabling market participants to obtain sufficient data about the company. The capital requirement is grouped into various capital brackets, which are differentiated depending on the type of (equity) capital necessary. The major components are tier 1 capital (going-concern capital) and tier 2 capital (gone-concern capital). Tier 1 capital consists of common equity tier 1 capital and additional tier 1 capital. To be classified for the different tiers, various criteria must be fulfilled (Basel Committee on Banking Supervision, 2011, 13–19). However, in general, it can be stated that tier 1 capital is used by a bank to absorb losses so that it is not compelled to quit its operations. Tier 1 capital comprises, for example, common shares issued by the bank, stock surplus and retained earnings. In contrast, a bank absorbs its losses with tier 2 capital in the event of its winding up or liquidation. Unaudited retained earnings, unaudited reserves and general loss reserves are examples of tier 2 capital. Basel III has also introduced two new buffers: the capital conservation and the counter-cyclical buffer. The aim of the capital conservation buffer is to establish a capital reserve outside periods of stress, which can then be used if losses occur. Now, banks have a buffer before reaching the binding minimum capital requirements that would automatically lead to supervisory consequences. The counter-cyclical buffer is used during periods of excess aggregate credit growth, mostly associated with the beginning of systemic risk in an economy, such as a real estate bubble. Both buffers have to consist entirely of common equity tier 1 capital. To counteract the moral hazard of ‘too big to fail’, the European Banking Authority defines global systemically important institutions as well as other systemically important institutions, which are obliged to maintain an extra buffer. Furthermore, each member state can implement a systemic risk buffer for the financial sector or one or more subsets of that sector. Also, these buffers have to consist of and be supplementary to common equity tier 1 capital (European Union, 2013a, Art. 131–133). The exact numbers are shown in Table 3.1.

A further important aspect emphasised by Basel III is concerned with the leverage ratio of financial institutions in general. The minimum capital requirements allow a risk weighting of a bank’s different assets – residential real estate is consequently underweighted. The leverage ratio, a simple non-risk-based measurement, monitors a bank’s capital structure independently from the risk-based requirements. This ratio divides tier 1 capital by the total exposure of the bank. Currently, there is a minimum capital ratio of three per cent planned. The aim of this method is to restrict the build-up of excessive leverage based upon a highly relevant ratio for real estate financing institutions with their large debt volumes (Basel Committee on Banking Supervision, 2014). Another important ratio is connected to the available liquidity of the banks. This liquidity ratio was introduced to force banks to hold sufficient high-liquidity assets to meet their total net cash demands for 30 days(see Basel Committee on Banking Supervision, 2013).
Table 3.1 Phase-in arrangements of Basel III requirements into European Union law

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<tbody>
<tr>
<td>Leverage ratio</td>
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<td>Supervisory monitoring</td>
<td>Parallel run: 1 January 2013–1 January 2017 Disclosure starts 1 January 2015</td>
<td>Migration to pillar 1</td>
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<td>Minimum common equity capital ratio</td>
<td>3.50%</td>
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<tr>
<td>Capital conservation buffer</td>
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<td>0.625%</td>
<td>1.25%</td>
<td>1.875%</td>
<td>2.50%</td>
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<td>Minimum common equity plus capital conservation buffer</td>
<td>3.50%</td>
<td>4.00%</td>
<td>4.50%</td>
<td>5.125%</td>
<td>5.75%</td>
<td>6.375%</td>
<td>7.00%</td>
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<td>Phase-in of deductions from CET1 (including amounts exceeding the limit for DTAs, MSRs and financials)</td>
<td>20%</td>
<td>40%</td>
<td>60%</td>
<td>80%</td>
<td>100%</td>
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<td>Minimum tier 1 capital</td>
<td>4.50%</td>
<td>5.50%</td>
<td>6.00%</td>
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<td>6.00%</td>
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<td>Minimum total capital</td>
<td>8.00%</td>
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<tr>
<td>Minimum total capital plus conservation buffer</td>
<td>8.00%</td>
<td>8.00%</td>
<td>8.00%</td>
<td>8.625%</td>
<td>9.25%</td>
<td>9.875%</td>
<td>10.50%</td>
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<td>Capital instruments that no longer qualify as non-core tier 1 or tier 2 capital</td>
<td>Phased out over 10-year horizon beginning 2013</td>
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<td>Counter-cyclical capital buffers (determined through national regulatory authority)</td>
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<td>Liquidity coverage ratio</td>
<td>Observation period begins</td>
<td>Introduce minimum standard</td>
<td>0.000–0.625%</td>
<td>0.000–1.250%</td>
<td>0.000–1.875%</td>
<td>0.000–2.500%</td>
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<tr>
<td>Net stable funding ratio</td>
<td>Observation period begins</td>
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<tr>
<td>Systemic risk buffer</td>
<td>0.00–3.00%</td>
<td>0.00–5.00%</td>
<td>0.00–5.00%</td>
<td>0.00–5.00%</td>
<td>0.00–5.00%</td>
<td>0.00–5.00%</td>
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Note: Shading indicates transition periods; all dates are as of 1 January.

a Omitted in the European Union. CET1, common equity tier 1 capital; DTA, deferred tax asset; MSR, mortgage servicing rights.
Source: Basel Committee on Banking Supervision (2011, 69)
Relevance for the real estate market

Although real estate financing is not the main target of these regulations, the amendments will also be binding for all financial institutions that are active in the real estate financing sector. The more stringent equity capital adequacy requirements as well as the implementation of a minimum leverage ratio and liquidity standards for banks are likely to have a negative impact on the financing possibilities for all real estate investments and their risk-weighted assets (Kröncke et al., 2014, 64–66).

To analyse the effects of Basel III on real estate financing, it is necessary to differentiate between non-residential and residential as well as between private and commercial real estate sectors. Furthermore, the current quantitative easing policy in the euro zone is keeping the interest rate at a low level. The effects on the residential market – particularly in the private sector – are estimated to be marginal. Although financing conditions can become more tightened (such as with regards to capital adequacy requirements or to the activation of a counter-cyclical capital buffer), borrowers of residential housing loans will still be able to find favourable conditions, even for long-term loans. Compared with the US and the situation after the sub-prime mortgage crisis, some real estate refinancing markets in Europe were first functioning well, due to their covered bond markets, a second refinancing source for a bank besides mortgage-backed securities. Twelve countries had already introduced covered bond legislation prior to the year 2000. Table 3.2 gives a full list of covered bond legislation in Europe. This advantage has been lost over the past few years because of a more intense public debt crisis and a slower recapitalisation of the European banks in general. Consequently, conditions (risk surcharges, maturity and so on) for financing non-residential properties will presumably deteriorate over the next years, reflecting the higher risks that this type of property actually brings with it. But all risk surcharges (for example 50–100 basis points) are on an absolute level low in the continuing period of low-level interest.

One of the aims of Basel III is the establishment of an enhanced risk-assessment provision and the backing of risk with equity capital. Having fully exploited the increased efficiency, the financial institutions will attempt to pass these higher equity capital costs on to the borrower in the form of higher interest rates, thus limiting access to loans. Irrespective of Basel III, loan providers are already taking a closer look at the quality of any property with regard to its adaptability for potential use by third parties. Any loss of quality will result in higher interest rates. However, there is no evidence of a general credit crunch at the moment, especially with the interest rates of the central banks being at historically low levels. Loans with solid loan-to-value ratios together with good-quality properties will bring few problems when it comes to a loan extension or a new loan. However, for more poorly rated properties and higher loan-to-value ratios, interest premiums will be higher to cover the high risk for the financing institution in the case of a default. This is a lesson learnt from the 2008 financial crisis.

To limit the ability to minimise the capital requirements with risk-weighted assets or an off-balance structure, the simple leverage ratio will be introduced as a publicly available measure. Financial institutions that have focussed so far on the financing of high-volume projects, such as real estate or the public sector, will have greater difficulties reaching the minimum leverage ratio. The real estate industry emphasises this regulatory imbalance between the lower risk of these projects compared with corporate finance projects, neglecting however the cluster risk of such banks. It is assumed that the importance of such banks for the public sector and the public sector’s own financing will put special attention on the final adjustments to the size of minimum leverage ratio in 2018.

Most capital requirements are the same for all member states. However, counter-cyclical capital buffers can be independently determined by national regulatory authorities. This type
of buffer should reflect the macro-financial environment of a specific country and can add up to 2.5 per cent of the required equity capital. As of yet, most countries have still not used this buffer even though their central banks have issued warnings about real estate bubbles in their respective markets. Only Switzerland already set a ‘sectoral real estate’ buffer at one per cent on 30 September 2013 and increased it to two per cent on 30 June 2014, aiming to prevent an overheating of the residential real estate market (Swiss National Bank, 2016). Norway set this buffer at one per cent on 1 July 2015. In this case, the supervision authority is not specifically targeting the real estate sector but is trying to make its banks more resilient against current financial imbalances across its whole economy (Norwegian Ministry of Finance, 2013). Neither country is a member state of the EU.

The current macro-economic environment in Europe and the expansive monetary policy and low base rate of the European Central Bank (ECB) imply that the impacts of the new regulatory framework conditions are only having a limited effect on real estate financing. However, this might change once the base rates of the ECB pick up again. Theoretically,

Table 3.2 European covered bond market legislation, by year of introduction, as of December 2017

<table>
<thead>
<tr>
<th>Country</th>
<th>Year of introduction/most recent amendment</th>
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<tbody>
<tr>
<td>Denmark</td>
<td>1851/2007</td>
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<tr>
<td>Austria</td>
<td>1899, 1905, 1927/2005</td>
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<td>Germany</td>
<td>1900/2005</td>
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<tr>
<td>Switzerland</td>
<td>1931</td>
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<td>Spain</td>
<td>1981/2007</td>
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<td>Czech Republic</td>
<td>1995</td>
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<td>Slovakia</td>
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<td>Hungary</td>
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<td>Luxembourg</td>
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<td>Poland</td>
<td>1998</td>
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<td>Latvia</td>
<td>1998</td>
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<tr>
<td>France</td>
<td>1999/2010</td>
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<tr>
<td>Bulgaria</td>
<td>2000</td>
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<tr>
<td>Finland</td>
<td>2000/2010</td>
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<tr>
<td>Ireland</td>
<td>2002/2007</td>
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<td>Lithuania</td>
<td>2003</td>
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<td>Russia</td>
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<td>Sweden</td>
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<td>Norway</td>
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<td>Portugal</td>
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<td>Slovenia</td>
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<td>Ukraine</td>
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<td>Greece</td>
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<td>Italy</td>
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<td>Turkey</td>
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<td>Armenia</td>
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<td>Iceland</td>
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<td>The Netherlands</td>
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<td>United Kingdom</td>
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<td>Cyprus</td>
<td>2010</td>
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<tr>
<td>Belgium</td>
<td>2012</td>
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<td>Romania</td>
<td>2015</td>
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Source: European Covered Bond Council (2018, p. 131).
alternative forms of financing – debt funds or crowd funding – can reduce a funding gap in real estate financing, particularly in the riskier sectors. Recently, and similarly to other industries, real estate financing has been attempting to finance directly via the capital market, thus avoiding the intermediary role of banks. Several debt funds and bonds have been issued this way. On account of the lack of trust in these alternative instruments with their too-short histories and expected low values, it is likely that alternative financing will continue to be implemented only hesitantly and only for those projects that cannot be financed in a traditional way or only at high cost. As long as this new shadow banking promotion is not the aim of Basel III, further monitoring of the risks outsourced by the credit institutions will be necessary. To avoid this risk shift to less supervised financial institutions, the risk monitoring idea targeted by Basel III and Capital Requirements Regulation/Directive IV should be transferred to all larger financial institutions and a level playing field – that is, a uniform framework – should be created. Furthermore, a harmonised application of the evaluation process of the different national supervisory authorities for internal risk models used by financial institutions is required, at least at the European level. Otherwise, the same risk, such as for real estate loans, might be assessed differently.

Solvency II

Further consequences for the real estate market could be initiated by Solvency II. This directive for the business of insurance and reinsurance companies aims at facilitating the taking-up and pursuit of the activities of insurance and reinsurance through aligning the differing rules of the EU member states, providing a common legal framework and making it easier for insurance and reinsurance undertakings to cover risks and commitments situated within the European Union. The increased supervision of insurance groups and protection of creditors should contribute to the proper functioning of the internal market in Europe (European Union, 2009, 1–2).

General objectives

Solvency II – which had already been proposed by the European Commission prior to the sub-prime mortgage crisis – is a fundamental reform of the insurance regulatory regime within the EU (European Union, 2009). At first glance, it follows a similar operational approach to that of Basel III with the ‘three pillars’. Solvency II addresses quantitative, governance and risk management as well as disclosure and transparency requirements. The quantitative aspect includes the various risks that affect the required minimum capital for insurance companies. To calculate the solvency capital requirement, insurance companies may either use a standard model, which uses external calculated risk factors, or a (partially) internal model, which uses their own simulated risk data. These internal models are specifically designed for the respective insurance company, essentially reducing the required capital compared with the external model while still fulfilling the risk requirements (Munich Reinsurance Company, 2015). The different national European supervisory authorities have to review, approve and monitor such models.

Relevance for the real estate market

The Committee of European Insurance and Occupational Pensions Supervisors conducted five quantitative impact studies and a long-term guarantees assessment between 2005 and
2013. These studies aimed to test and calibrate the requirements for the risk management, the reports to supervisory authorities and the public, and the calculation of the implementing measures for the Solvency II framework. The results were then integrated into the final version of Solvency II. However, the European real estate industry deems the final standard decrease value of 25 per cent for all kind of properties (regions and types) to be too high and to differentiate insufficiently among regions and types. This value is mostly motivated by the real estate market in the UK, where the volatility is higher than in continental Europe and regulators are able to look back over a longer time when calculating the risk factor. The real estate industry argues that the Swiss Solvency Test, which became binding on 1 January 2011, assessed more realistically the risk of residential and commercial real estate: the former has a mean default risk of 10 per cent, and the latter 17 per cent.

Most European insurance companies, however, have announced that they will increase their real estate investment in their asset portfolios to guarantee the necessary return for their contracts during the low interest period. Until now, they have only hesitantly implemented their intention – and only in prime locations. However, as Solvency II will create the same rates for the risk covering of all properties in the standard model, it theoretically provides an incentive for investing in properties that have a higher return – and are thus, on average, riskier. The standard external risk model of Solvency II fails to adequately assess the real risk. Only a few European insurance companies will be able to use an internal model that would alleviate this problem, since the administrative resources needed are too high in relation to the percentage of real estate in the portfolio or the necessary data basis is not available. A partial internal model, which can be used by smaller insurance companies, could cover the real risks more effectively and could also prevent a distortion risk to the detriment of such companies. Even if the use of the standard model could theoretically lead to a higher risk shift in the real estate portfolio of European insurance companies, the real estate proportion in the total portfolio is, at around 10 per cent, small. The majority of assets consist of sovereign bonds with a currently low yield. Since the yield environment remains low with the current quantitative easing policy in the euro zone, stress tests on European insurance companies showed, for some of them, issues with fulfilling their long-term liabilities. During this time of low yields, we observe higher investment activities in infrastructure projects and insurance companies as real estate financers. So far, a systematic shift to higher direct real estate investments has not taken place. However, the focus on prime locations for company real estate investments is forcing property prices up and has increased the danger of regional property bubbles.

**Mortgage credit directive**

In the aftermath of the consequences of the US sub-prime mortgage crisis of 2007–2009 and the huge over-indebtedness or even homeless situation of some mortgage borrowers, the EU has tried to implement a directive to protect European borrowers from a similar situation and to avoid irresponsible lending and borrowing conditions for the home loan market in the future. In 2014, the EU published a directive which applies to secured credit and home loans and is supposed to increase the transparency, efficiency and competitiveness of the internal European market and to promote sustainable lending and borrowing. All credit intermediaries had to comply with the MCD by March 2016 for their retail customers. Its aim is to ensure, via better information on and for borrowers, responsible lending with a reduced risk of over-indebtedness; furthermore, better protection in the case of default.
**Documentation and precontractual information requirements**

The two requirements of providing standard precontractual information for borrowers through a European standardised information sheet and applying a consistent EU standard for the calculation of the annual percentage rate of charge are provisions requiring maximum harmonisation. For any other requirements of the MCD, such as the statutory permission requirement for mortgage credit intermediation, each member state may maintain or introduce more stringent provisions (see in particular: Art. 14(2)/17 and Annex I–II in European Union, 2014a).

**Conduct and procedural requirements**

At a glance, nine major conduct and procedural requirements are stipulated by this directive (European Union, 2014a, Art. 11, 12, 14, 18, 19, 23, 25 and Annex III):

1. Binding offer: lenders must make a binding offer or a conditional offer if a binding offer is made at a later stage of the lending process.
2. Advertising: the national law of a member state should involve disclosure requirements to protect the customer from misleading, poor and delusive advertising.
3. Tying and bundling: to protect mortgage customers from product tying that affects them negatively, certain rules for product tying should apply. These rules should allow the customer to take part in beneficial product tying while negative effects are restricted.
4. Seven-day reflection period: customers have the right of a seven-day reflection period; depending on the member state, this right will be granted in the pre- or post-sale period or as a combination of the two.
5. Assessment of customer creditworthiness: the possible increase in the value of residential properties cannot be the only condition of the customer creditworthiness, as there are various personal qualities that may influence a customer’s ability to repay a credit. To ensure that a customer is creditworthy, member states should give additional lead on criteria and methods to approve an individual’s creditworthiness.
6. Property valuations: proper and reliable valuation standards should be applied in the member states. Internationally renowned standards should be included.
7. Early repayment: to offer a higher level of competition and to ensure that the customer can react to specific life events (such as disability, divorce or unemployment), member states should guarantee the right of an early repayment to the customer. The customer’s exercise rights may include restrictions such as time limitations, different treatment with respect to the type of borrowing rate (fixed or variable) or life circumstances. In return, the lender may be entitled to an objectively justified amount to compensate the directly linked costs of an early repayment.
8. Foreign currency mortgages: to reduce the customer’s risk attached to credit agreements in a foreign currency, the directive recommends certain protection measures; the customer should be able to convert the currency of the credit agreement into an alternative currency.
9. Knowledge and competency: member states should support programmes that educate mortgage customers and thus lead them to better decisions. A monitoring system that verifies the knowledge and competency of creditors should be applied to ensure a high-level standard of professionalism.

Overall, the MCD aims to reach a high level of consumer protection by introducing minimum standards and by creating a common mortgage credit market in Europe. Mortgage
credit granting institutions – in Europe traditional private, savings and cooperative banks as well as insurance companies – and their independent credit intermediaries will have to meet these requirements to stay in the market. Scholars assume that the higher requirements will not only have the desired effect of avoiding credit offers to customers who are in the long-term unable to repay their loans but will also avoid, for example, loans to low-income retirees who want to borrow small amounts for an age-based conversion of their homes. The new requirements will put a higher focus on their lower income, compared with that of their working lifetime, and a lower weight on the property value, even after the conversion. On the supply side, a harmonised European mortgage market will allow financial institutions, especially in online marketplaces, to offer their products easily in different countries. This higher competition could lower the spread over the central interest rate for mortgage customers, an advantage that is almost irrelevant during the current low-interest period. In the long run, it will foster a pan-European mortgage market with lower costs and more information for customers.

**Alternative investment fund managers directive**

As a consequence of the financial and economic crisis of 2008, various EU-wide regulations were introduced to handle systemic risk. Beside the banking system, the alternative investment fund industry has come into the focus of policy makers, since alternative investment funds have so far only been lightly or even not regulated (including hedge funds, private equity, and real estate and infrastructure funds). Even if markets and investors do mostly benefit from activities of operating alternative investment fund managers (AIFMs), those recent trends in financial markets (over-indebtedness, off-balance risk securitisations, fund frauds and funds’ suspensions of redemption) have shown that negative developments of AIFMs can create additional risks that are transferred to the whole financial system. Furthermore, a proper risk management becomes more complex because of uncoordinated national operations within the EU single market (European Union, 2011, 1).

Thus, EU Directive 2011/61/EU (AIFMD) came into force on 21 July 2011, aiming to provide common requirements for the authorisation, supervision and marketing of AIFMs within the EU region. EU member states were required to transpose the provisions of the AIFMD into national law by 22 July 2013. The directive targets those investment funds not regulated under the UCITS Directive at EU level that account for around 75 percent of all collective investments by small investors in Europe (European Union, 2014b). In contrast to the UCITS directive, the AIFMD regulates the managers themselves rather than the fund product, since the EU identifies the manager as the driving force behind the legal structure of the fund.

**General objectives**

AIFMs are subject to an authorisation process and a harmonised and stringent regulatory framework for management or marketing activities within the EU (European Union, 2011, 1). Besides the implementation of an internal market for alternative investment funds (AIFs), common requirements for the authorisation, supervision and marketing of AIFMs are being introduced to increase investor protection and to provide detailed information of operating AIFMs to regulators so that they can identify and prevent related systemic risk trends that may have a negative impact on investors and financial markets in the EU. More precisely, investor protection is being increased significantly and the market is being reinforced by
increased competition and options for investors’ choices under high and consistent regulation. This is mainly being achieved by a greater transparency towards investors, supervisors and employees of the companies that the fund invests in.

EU funds managed by an EU manager are marketed across the EU under an AIFMD passport if all requirements of the directive are complied with. Non-EU managers are not able to obtain such a passport. Thus, their EU or non-EU funds are only marketed under national private placement regimes. However, most of the AIFMD requirements also apply to non-EU managers of non-EU AIFs if the AIF is raising equity capital within the EU. After 2015, non-EU funds may also be allowed to obtain an AIFMD passport for distributing their funds within the EU. The European Securities and Markets Authority recommended in 2016 that Switzerland is granted an authorisation for using the passport and a further extension including especially Singapore and the US is conceivable.10

Authorisation process and main features

The first step within the authorisation process for AIFMs is the submission of a registration application to the competent authorities of the respective member state. The application identifies the management and the shareholders, information on remuneration policies and practices, as well as information on delegated services and tasks (European Union, 2011, 20). To receive authorisation, the AIFM also needs to own a minimum of capital and funds based on capital requirements listed below, to provide an activity programme including a description of the organisational structure and contemplated delegation, and to implement remuneration policies and arrangements for a depositary appointment. The directive also includes behavioural principles for managers to ‘act honestly, with due skill, care and diligence, fairly in conducting their activities [and] in the best interests of the fund, the investors […] and the integrity of the market’ (European Union, 2011, 23).

The supervisory authorities of the member state in which the office of the fund is registered (or the member state of reference for non-EU AIFMs) only grant authorisation if they consider the AIFM to meet all requirements of the AIFMD, but authorisation is then also valid in all other member states of the EU. If authorisation is successful, the AIFM is able to execute investment management activities, especially portfolio and risk management, administration, marketing and other activities directly linked to the fund. The main features of the directive are displayed in Figure 3.1. These are capital requirements, delegation, conflicts of interest, risk/liquidity management, remuneration, valuation, transparency and depositary.

Capital requirements

To ensure the continuous and stable administration and management of an AIF, the fund manager is required to hold a minimum capital of €125,000 for an externally managed AIF. If the fund is internally managed, however, the minimum capital requirement is extended to €300,000. Furthermore, two basis points of the fund’s portfolio value that exceeds €250 million must be held as additional funds, but the total sum of the capital requirement plus the additional amount is capped at €10 million. Member states can also authorise the AIFM to obtain up to 50 per cent of the additional funds held either by a guarantee provided from a credit institution, an insurance company registered in a member state, or – in a country with regulations deemed to be equivalent – by the competent authorities (European Union, 2011, 22).
Delegation

The AIFM is responsible for performing investment management functions of one or several AIFs and for ensuring compliance with the AIFMD, but it can also delegate functions to external institutions. The AIFMD provides an adequate and highly restrictive framework for an external delegation of functions. The overall aim of this delegation framework is to ensure that the fund is still managed in the best interests of investors and that the delegation does not have any negative effects in terms of supervision and monitoring standards. A delegation of portfolio or risk management that exceeds the remaining internally managed functions to a significant extent results in the AIFM becoming a letterbox entity, which is strictly prohibited by the directive. A proper due diligence process provides the basis for the choice of an adequate delegate, who must be sufficiently experienced in undertaking delegated functions (Muller and Dogniez, 2013, 17).

Conflicts of interest

Conflicts of interest may occur between stakeholders linked to the AIF, resulting in negative effects for the fund and the investors. Stakeholders linked to the fund include the AIFM and operating managers, employees or persons directly or indirectly linked to the AIFM, the managed fund and the investors. According to the directive, the AIFM is required to implement organisational and administrative structures for conflict identification and to run sufficient monitoring, management and prevention measures. However, requirements to identify such conflicts between the fund manager and the investor, or even between one investor and another, can be complex and difficult to realise in practice.
If conflicts of interest still occur, the AIFM is required to make general disclosures regarding the nature of the conflict before undertaking business on an investor’s behalf (Williams et al., 2012).

**Risk and liquidity management**

The AIFM is responsible for the implementation of an adequate risk management system for a proper identification, management and monitoring of all risks to which the managed fund is exposed. Furthermore, the AIFMD requires a functional and hierarchical separation of the fund’s risk management and operations, as well as the implementation of an efficient liquidity management system based on stress-testing procedures. It is important to note that the AIFMD does not limit the employed investments or strategies of an AIF. However, investment strategies, the liquidity profile and the redemption policy have to remain consistent at all times (European Union, 2011, 25).

The AIFMD requires fund managers to determine an individual maximum leverage limit for each fund managed. Relevant determinants for setting the leverage limit include the investment strategy, the sources of leverage, the asset–liability ratio, the need to limit the exposure to a single counterparty and the extent of collateral. Competent authorities, however, may lower imposed leverage limits again when raising concerns about systemic risk and disorderly markets (European Union, 2011, 25). Investors are informed about the employed total leverage level by the AIFM on a regular basis to ensure transparency.

**Remuneration**

The AIFMD also contains requirements for remuneration policies and practices of senior management, risk takers, control functions and any other employee whose professional activities have a significant effect on the risk profile of the managed fund (European Union, 2011, 4). The implemented remuneration policy is required to encourage only risk taking that complies with the risk profile, incorporation rules or instruments of the managed fund. Performance-based parts of remunerations are spread over time, taking redemption policy and investment risks of the fund into consideration. The relevant performance of employees is measured using a multi-year framework following the lifecycle of the fund. Furthermore, variable and fixed remuneration parts need to be well balanced, so that at least 50 per cent of the variable remuneration consists of shares or units and 40 per cent is deferred for a minimum of three or five years (Muller and Dogniez, 2013, 15).

**Valuation**

Adequate and consistent valuation methods for a proper and independent valuation of the AIF’s assets provide the basis for a transparent and consistently regulated AIF sector. AIFMs can either perform the valuation themselves when they are functionally independent of the AIF’s portfolio management and implemented policies ensure the mitigation of any conflict of interest, or they can engage an external, completely independent appraiser. The engagement of an external appraiser requires a professional registration recognised by national law or regulatory provisions as well as personal guarantees indicating the qualification for appropriately performing the valuation process. The independent calculation and valuation of assets is required at least once a year. However, this is controversially discussed, since it might increase operation and management costs significantly.
Transparency

To ensure investor protection, the AIFMD also includes certain transparency and disclosure requirements. These disclosures to investors include the investment strategy and objectives, all assets the fund can invest in, as well as employed techniques, details of all related risks, investment restrictions, and the kind and source of leverage used. Furthermore, information on investment strategy and policy changing procedures, risk management and valuation methods, fees and charges, costs and expenses, and preferential treatment given to particular investors must be provided by the AIFM. Investors also have to be immediately notified about significant changes concerning these fields. Moreover, an annual report must be provided to investors upon request no later than six months subsequent to the end of the financial year. The AIFM is also required to meet various other periodical reporting obligations, including informing the competent authorities of their domicile, such as information on liquidity, risk management and results of stress tests (European Union, 2011, 33).

Depositary

The asset supervision of each managed AIF is done by an external depositary who is assigned to the managed fund via a written contract. EU AIFMs of non-EU funds that are marketed to professional investors within the EU according to national private placement regimes are not entirely subject to these depositary conditions. However, they are also required to engage one or more external institutions for operating their fund’s cash monitoring, safe-keeping and oversight duties (Muller and Dogniez, 2013, 19).

Relevance for the real estate market

Real estate fund managers who fall under the AIFMD have to meet regulations that are transposed into national law of the member state of the fund’s origin or the referring member state when located outside the EU. For the real estate sector, AIFs capture many open-ended and closed-ended listed and unlisted real estate funds, but appeal especially to non-listed funds (European Union, 2011, 2).

The implementation of the AIFMD may result in notably increased operating costs, especially because of the capital requirements, the designation of external depositaries, external appraisers and the internal reorganisation needed to meet compliance and reporting requirements (Martougin, 2011). Consequently, higher operating costs could be reflected in a higher annual management fee rate. However, the management fee rate – measured by the total expense ratio on gross asset value – does not show significantly higher rates for the past few years (INREV, 2011, 19; INREV, 2016).

The directive is assumed to encourage consolidations within the real estate fund industry, since large funds benefit from European passporting by consolidating their entities throughout Europe (Martougin, 2011). For the UK and Ireland, many fund managers believed that the directive would reduce the competitiveness of the EU’s alternative investment funds industry due to fewer non-EU managers operating in Europe before the AIFMD was introduced.11 The regulatory environment is thus a significant factor for the choice of a fund domicile, resulting in a reduced choice for investors. Fund managers also expected that redemption terms would be affected and leverage figures, which are conditional on many different factors, potentially confuse investors.

REITs remain a special case in the context of the AIFMD. According to the criteria for AIF determination by the European Securities and Markets Authority, REITs may have a
general commercial or industrial purpose due to property development or property retail. Thus, REITs are generally not classified as collective investment undertakings and, if they fall within the scope of the AIFMD, are based on an individual assessment (European Securities and Markets Authority, 2012, 16 and 36).

**REIT regulation**

In total, there are around 104 REITs listed in Europe, with the majority of them based in the UK. Numerous European countries have already introduced national acts to attract (foreign) equity capital, especially due to the increase in usage of that investment vehicle. In general, there are different reasons for this surge in capital invested in REITs. They offer a good chance for international investors to invest in foreign real estate without detailed knowledge of that particular market. Another reason can be seen in the tax exemption rules, which increase the attractiveness for investments in REITs. Apart from that, the real estate bubble negatively affected several European countries in the late 2000s. After the bubble burst, numerous developments were either unfinished or could be acquired at low prices. In particular, REITs allowed the Spanish and Greek governments to liquidate their assets (Pirolo and Whelan, 2014).

**General aspects in Europe**

So far, there is no uniform REIT Act in the EU, so that every European country can decide whether this investment vehicle should be available or not. Worldwide, a total of 37 countries have REIT legislations in place, of which 13 are European countries (European Public Real Estate Association, 2015, 2). By 2015, the worldwide market capitalisation for REITs was roughly €883 billion. In 2014, the European market capitalisation amounted to only around EUR 172 billion. The common identifiers for REITs are the tax exemption rules excluding them from corporate taxation and the investment focus on real estate. To guarantee the tax payment on the investor level, REITs are also strictly regulated in Europe regarding their dividend payout ratio. In most cases, REITs have to distribute roughly 90 per cent of their taxable income. These rules are the reason why REITs are used as an income-generating asset rather than for accretion. In Europe, in 1969, the Netherlands was the first country to introduce national laws concerning REITs. Most other European countries introduced their legislations much later, generally between 2003 and 2007. The latest country to adopt REIT rules was Ireland in 2013.

**Different REIT requirements in Europe**

Because numerous countries have introduced their own national regimes since the beginning of this millennium, the privately organised European Public Real Estate Association (EPRA) has tried to introduce some guidelines regarding minimum REIT recognition requirements. These requirements are: the legal form has to be a corporate; they have to be listed; and the minimum mandatory distribution of income has to be at least 80 percent of after-tax income (European Public Real Estate Association, 2009, 4). However, there is no legally binding EU law in place, and every country has its own REIT recognition guidelines, so the different REIT requirements vary greatly. Table 3.3 provides the most important characteristics for the seven major European economic countries.
Table 3.3 Real estate investment trust market characteristics of seven major European economic countries

<table>
<thead>
<tr>
<th>Country</th>
<th>Market value (€million)</th>
<th>REITs (n)</th>
<th>Regulation start (year)</th>
<th>Payout ratio</th>
<th>Income type</th>
<th>Leverage</th>
<th>Tax treatment on REIT level</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium</td>
<td>5,640</td>
<td>8</td>
<td>1995</td>
<td>80</td>
<td>Net profit</td>
<td>Loans max. 65% of TA. Interest expenses max. 80% of total income</td>
<td>Rental income excluded. Capital gains tax-exempt</td>
</tr>
<tr>
<td>France</td>
<td>18,975</td>
<td>20</td>
<td>2003</td>
<td>95</td>
<td>Tax exempt profit</td>
<td>No specific leverage restriction but French thin capitalisation rule has to be applied</td>
<td>Tax exempt</td>
</tr>
<tr>
<td>Germany</td>
<td>1,837</td>
<td>3</td>
<td>2007</td>
<td>90</td>
<td>Net income</td>
<td>Min. 45% of TA of RE must be equity</td>
<td>Tax exempt</td>
</tr>
<tr>
<td>Greece</td>
<td>293</td>
<td>3</td>
<td>1999</td>
<td>50</td>
<td>Net profit</td>
<td>Max. leverage 75% of TA</td>
<td>Income taxed at 10% of ECB fund rate plus 100 basis points. Capital gains exempt</td>
</tr>
<tr>
<td>Italy</td>
<td>925</td>
<td>2</td>
<td>2007</td>
<td>70</td>
<td>Tax exempt profit</td>
<td>As stated in company bylaws</td>
<td>Income and capital gains from real estate related activities are tax exempt. Other income subject to ordinary taxation</td>
</tr>
<tr>
<td>The Netherlands</td>
<td>28,963</td>
<td>5</td>
<td>1969</td>
<td>100</td>
<td>Taxable profit</td>
<td>60% of fiscal book value of real estate</td>
<td>Tax exempt</td>
</tr>
<tr>
<td>UK</td>
<td>69,399</td>
<td>33</td>
<td>2007</td>
<td>90%</td>
<td>Tax property rental profits</td>
<td>Property profit: Property cost with a ratio of 1.25</td>
<td>Tax exempt residual business 20%</td>
</tr>
</tbody>
</table>

ECB, European Central Bank; max., maximum; min., minimum; REIT, real estate investment trust; TA, total assets.

Apart from these seven countries, another six European countries have REIT legislation in place that differs significantly from that in Table 3.3. The most distinct differences are as follows:

- With regard to the minimum share capital required to create a REIT, only €40,000 is needed in Lithuania, whereas it takes €40 million in Italy.
- The required payout ratio ranges from no obligations in Lithuania to up to 100 per cent of the operative incomes taxable profit in the Netherlands.\textsuperscript{14}
- Asset level restrictions range from rather relaxed guidelines in France, which state that ‘principal activities must be in renting out properties’, to strict laws in Spain, stating that 80 per cent of income and 80 per cent of assets have to be directly linked to real estate, requiring a minimum holding period of 3 years.
- Some countries are very restrictive in terms of leverage, such as Lithuania, where a maximum of 50 per cent of real estate value can be debt financed. However, in Spain, no restrictions on leverage apply at all.\textsuperscript{15}

Differences can also be found in taxation obligations. In general, the income component on the REIT level is tax exempted; in Greece however, the tax rate accounts for 10 per cent of the current ECB central interest rate plus 100 basis points, which in fact is almost zero per cent currently.\textsuperscript{16} Whereas on the individual shareholder level, the personal tax rate is usually applied, this income is tax exempt in Greece, essentially subjecting profits from REITs in Greece to nearly zero per cent tax in total.

Concerning the tax treatment of foreign investors or of foreign REITs, the individual laws also vary. Generally, it can be stated that foreign investors are charged at a similar rate to local shareholders, although foreign investors may benefit from tax treaties between countries. The most notable difference can be found in Greece, where foreign shareholders do not have to pay any tax at all. However, foreign REITs often do not experience the same benefit: in fact, in most European countries, foreign REITs are not eligible for tax deductions, and therefore the normal corporate tax rate applies. This is due to the fact that most foreign REITs are not recognised as such under the local tax regimes. The Netherlands are an exception to this rule, though. Foreign REITs are tax exempt if they are comparable ‘in nature, form and behaviour’ to their qualifying Dutch counterparts (European Public Real Estate Association, 2015, 142).

Summing up, despite the tax benefit of REITs, the general dominance of real estate funds in Europe, their strongest argument of being decoupled from the stock market and the generally lower (continental) European ratio of stockholders has left REITs only little room for an expansion in Europe over the last years.

**Regulation of fund managers and investment vehicles in Asia**

While real estate is a significant asset class for investors in Asia, the vehicles by which real estate is managed vary substantially across countries. Country-specific legislative laws and policies dictate the way real estate is managed. The landscape is varied from family-oriented businesses with a traditional value attached to holding real estate to global fund management organisations. Investment vehicles also range from private and publicly listed development companies, equity and debt funds, and REITs.

This section focuses only on REITs in Asia and examines the differences in legislative framework for selected Asian countries. By way of overview, we will better understand why REITs emerged as a strong investment vehicle in Asia.
Basel III in Asia

The general description of Basel III is set forth above, but its implications for Asia are different than for Europe. The most important difference between Europe and Asia is the relative difference in economic integration: Europe is quite integrated, while Asia is not. Within Asia, banking systems vary dramatically across countries. Some countries (such as China) have banks that are state-owned enterprises, others have private enterprises, and still others have private enterprises with substantial government intervention. In some countries, banking is quite sophisticated, meaning, among other things, that capitalisation levels are based on models of risk, whereas in others, capitalisation levels are based on simple risk-weighting heuristics.

Ironically, one of the outcomes of this is that more sophisticated banking systems, such as Japan’s, are more likely to fail to meet the capital requirements of Basel.

Solvency II in Asia

Although Solvency II is a European regulatory framework for capitalising insurance companies, it affects Asian multinational insurance companies that wish to do business in the EU. Specifically, if insurance companies external to Europe do not meet Solvency II standards, they may need to carry higher levels of capital to do business in Europe.

CG Capital Ideas (2017) notes that ‘Japan and Australia attained provisional third-country equivalence status for group solvency (Article 227). This status is valid for ten years and reduces the administrative burden for the Solvency II calculation of subsidiaries in the European Economic Area (EEA).’ Ernst & Young (2015) developed a table laying out the sophistication of insurance regulation in Asia and the appetite for meeting the requirements of the Solvency II framework, by country.

Mortgage regulation in Asia

Table 3.5 provides a summary of differences in mortgage supervision across Asia. Perhaps the most noteworthy thing about this table is that there is much variation in what is regulated

### Table 3.4 Sophistication levels of solvency regulations in Asia

<table>
<thead>
<tr>
<th>Market</th>
<th>Ernst &amp; Young Sophistication Score (1–3)</th>
<th>Ernst &amp; Young Solvency II Appetite Score (1–4)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Singapore</td>
<td>3</td>
<td>2</td>
</tr>
<tr>
<td>Malaysia</td>
<td>3</td>
<td>2</td>
</tr>
<tr>
<td>Indonesia</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>Thailand</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>Vietnam</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Mainland China</td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>South Korea</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>Taiwan</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>Japan</td>
<td>3</td>
<td>4</td>
</tr>
</tbody>
</table>

Note: Most of Asia, regardless of regulatory sophistication, does not consider complying with Solvency II to be a priority (Ernst & Young, 2011, 6).
across Asia. China uses nearly every potential regulatory tool, while Thailand appears to be lightly regulated. It is particularly surprising that, given its historical vulnerability to currency shocks, Thailand does not regulate mortgage currency exposure.

Even when a regulation appears to be ubiquitous, such as loan-to-value ratio limits, its implementation can vary across countries, such as loan-to-value maximums that can range from 70 to 80 per cent across Asia. Perhaps more important, loan terms vary considerably, meaning that amortisation speeds vary and, therefore, implied loan-to-value maximums once loans have seasoned are quite different across countries.

### REIT regulation in Asia

REITs did not exist in Asia prior to 2001. The investment community gained exposure to real estate market through either the ownership of direct property or listed property company shares, property funds and, to some extent, through mortgage-backed securities in market, such as Singapore and Korea.

The main impetus behind the creation of REIT in Asia was the 1997 Asia financial crisis, which left many corporations in Asia saddled with huge debts and undervalued real estate. Financial institutions in countries such as Japan, Taiwan and South Korea were loaded with foreclosed properties. Regulators viewed REITs as a feasible route to recapitalise the corporate balance sheet and as a means of revitalising the real estate market. Korea launched its corporate restructuring REIT (CR-REIT) in 2002 to take over assets from distressed firms.17 Japanese developers considered REITs as an alternative source of raising funds as lenders shunned commercial mortgage loans following the collapse of Japanese real estate market in the 1990s. In Taiwan, Fubon REIT was backed by properties from Fubon Financial, a financial institution.

Corporations in Singapore, Hong Kong and Malaysia, in contrast, viewed REITs as a potential route to recycle capital through the divestment of their non-core real estate.

---

**Table 3.5 Differences in mortgage supervision across Asia**

<table>
<thead>
<tr>
<th>Regulatory tool</th>
<th>Countries/regions using tool</th>
</tr>
</thead>
<tbody>
<tr>
<td>Counter-cyclical provisioning</td>
<td>People’s Republic of China (PRC), India</td>
</tr>
<tr>
<td>Loan-to-value ratio maximums</td>
<td>PRC, Hong Kong, Indonesia, Japan, South Korea, Malaysia, Philippines, Singapore, Thailand</td>
</tr>
<tr>
<td>Debt service ratio maximums</td>
<td>PRC, Hong Kong, South Korea</td>
</tr>
<tr>
<td>Counter-cyclical tightening</td>
<td>PRC, Hong Kong, South Korea, Malaysia, Philippines, Singapore, Thailand</td>
</tr>
<tr>
<td>Credit limits</td>
<td>PRC, Hong Kong, India</td>
</tr>
<tr>
<td>Counter-cyclical supervision</td>
<td>PRC, Hong Kong, South Korea, Malaysia, Singapore</td>
</tr>
<tr>
<td>Capital requirements</td>
<td>India, Malaysia</td>
</tr>
<tr>
<td>Sector exposure limits</td>
<td>South Korea, Malaysia, Philippines, Singapore</td>
</tr>
<tr>
<td>Capital surcharges for ‘too big to fail’ banks</td>
<td>PRC, India, Philippines, Singapore</td>
</tr>
<tr>
<td>Liquidity and funding requirements</td>
<td>PRC, India, South Korea, Malaysia, Philippines, Singapore, Thailand</td>
</tr>
<tr>
<td>Loan-to-deposit requirements</td>
<td>PRC, South Korea</td>
</tr>
<tr>
<td>Foreign exchange exposure limits</td>
<td>South Korea, Philippines</td>
</tr>
<tr>
<td>Limits on currency mismatches</td>
<td>India, Malaysia, Philippines</td>
</tr>
</tbody>
</table>

CapitaLand, a major property developer in Singapore, spun-off their real estate into two REITs, CapitalMall Trust and Capital Commercial Trust, to release capital for them to pursue more profitable property development projects in China, India and Vietnam. The same strategy was adopted by property developers in Malaysia. The largest Malaysian REIT, Starhill REIT, was created through the injection of commercial properties by property developer YTL Land Bhd. Besides releasing the capital from assets injected into REITs, such property companies still earn fees for managing the properties under the REITs.

Factors that worked in favour are:

1. Ample investible assets: the amount of investible assets in Asia ex-Japan was estimated at US$500 billion by UBS in 2005. A large chunk of these properties is owned by non-real estate corporation such as financial institutions, transport and retail companies, as well as government agencies. Non-real estate corporations own an estimated US$81 billion of investible real estate in the Asia region ex-Japan. These non-real estate companies have a financial incentive to divest their assets holdings to release capital and operate under a lighter balance sheet.

2. Favourable risk-return characteristics: from an investment perspective, the risk-return characteristics of REITs bode well for individual and institutional investors looking to diversify and to earn stable income returns. In low interest regime countries, such as Japan, REITs provide larger yield spread between REIT dividend yield and deposit rates, which made an attractive investment instrument in Japan.

3. Demographics: an ageing population and high saving rate in Asian countries, such as Singapore, Hong Kong, Korea and Taiwan, creates a ready demand for high income yielding investment products such as REITs. Pension funds in these countries are continuously looking for stable income stream to match their near future liabilities commitment. Wealth and property fund management firms have been venturing into the untapped funds in Asia. REITs have become one of the best candidates for these fund managers to gain exposure to real estate market for liquidity and diversification benefits purposes.

The acceptance of REIT as a class of legitimate investment products in Asia and increasing REIT product knowledge among retail investors contributed to the development of REITs. The setting up of the Asian Public Real Estate Association in June 2005 further provided a platform for Asian REITs to lobby for conducive and competitive REIT legislation from the regulators. Similar lobby groups are seen in the developed markets, such as the National Association of Real Estate Investment Trusts in the US and the European Public Real Estate Association in Europe.

Ooi, Newell and Sing (2006) identify three key factors that impeded the growth of REIT in Asia:

1. Restrictive legislation: the REIT legislative regimes in many countries in regard to gearing and foreign ownership of local real estate are more restrictive compared with that in the US (see the next section for comparison of REIT legislation between Asia, US and Australia REIT).

2. Tax transparency: the REIT tax transparency status, which shelter shareholders from double taxation, may not be that attractive in countries that practise an imputed tax system.

3. Low property yield: the low property yield by prime properties in Asia made it difficult to replicate and sustained the high dividend payout of US REITs.
4. High concentration risk: Asia REITs tend to have limited holdings of properties in their portfolios. US and Australia REITs have an average of 150 and 40 in their portfolios, respectively (Eldik, 2005). Most Asia REITs hold fewer than 30 properties, the prescribed number of properties needed to enjoy the diversification benefits according to conventional portfolio investment theory. This inevitably translates into higher volatility in returns.

5. Size: a related issue is the REIT size, which could enable them to enjoy economies of scale. Asia REITs are generally small capitalised firms, which could impede their efforts to improve yields over the long-term through cost saving strategy. Ambrose and Linneman (2001) find that an increase of a market capitalisation of US$1 billion could reduce capital costs by about 2.2 per cent for US REITs. In addition, they also find that large REITs tend to be more profitable, have higher rental revenue ratio and incur lower implied capitalisation rates.

Notwithstanding the obstacles cited above, Asia witnessed a REIT initial public offering (IPO) boom during 2005–2006 with 66 IPOs come to the market during these two years. In comparison, the IPO boom in the US during 1993–4 saw some 89 IPOs.

**Comparison of Asian REIT legislative frameworks**

The legislative framework for REITs in Asia is generally adapted from the US and Australian REIT markets, albeit with different country-specific variations. Table 3.5 provides a cross-comparison between Asia REIT regulatory regimes. For ease of reference, Japan REITs are referred to as J-REITs, Singapore REITs as S-REITs, and so on.

Some key difference should be highlighted:

1. External management structure: many REITs in Asia subscribe to an externally managed structure where a separate fund management company is set up to manage the REIT. This is contrary to the US REIT structure, which favours internal management. Externally managed REITs tend to create agency problems, since the REIT management fees are often pegged to the size of the portfolio under their management. This provides an incentive to enlarge the portfolio size even to the detriment of shareholders. In addition, most Asia REITs are structured as captive REITs, where the fund management company is a wholly owned subsidiary of the REIT sponsor, normally a property developer that injected the properties into the REIT during IPO. The fund management company of Starhill REIT – the biggest Malaysia REIT – is 70 per cent owned by its sponsor, YTL Corporation Bhd. In Singapore, CapitaCommercial Trust is managed by CapitaCommerical Trust Limited, a wholly owned subsidiary of its sponsor, CapitaLand limited.

2. Geographic coverage: all Asia REITs are allowed to hold properties outside their home countries, with provisos in the case of Taiwan and the Philippines. Regulators in Singapore and Hong Kong have been proactive in promoting the cross-border listing of REITs. Hong Kong cross-border REITs capitalise on acquiring investment grade properties in mainland China.

3. Property development: Japan, Taiwan, Thailand, Malaysia and Philippines REITs are prohibited from undertaking property development activities. For the other countries, the degree of property development activities allowed to REITs varies from 10 to 30 per cent.
Table 3.6 Comparison of Asian real estate investment trust legislative frameworks

<table>
<thead>
<tr>
<th></th>
<th>Japan</th>
<th>Singapore</th>
<th>Hong Kong</th>
<th>Taiwan</th>
<th>Thailand</th>
<th>Malaysia</th>
<th>South Korea</th>
<th>Philippines</th>
</tr>
</thead>
<tbody>
<tr>
<td>Management structure</td>
<td>External</td>
<td>External</td>
<td>External/ internal</td>
<td>External/ internal</td>
<td>External</td>
<td>External</td>
<td>Internal/ external</td>
<td>External</td>
</tr>
<tr>
<td>Invested in real estate or real estate related assets (%)</td>
<td>75</td>
<td>75</td>
<td>100</td>
<td>75</td>
<td>75</td>
<td>75</td>
<td>70</td>
<td>75</td>
</tr>
<tr>
<td>Foreign assets</td>
<td>OK</td>
<td>OK</td>
<td>OK</td>
<td>OK (with central bank approval)</td>
<td>OK</td>
<td>OK</td>
<td>OK</td>
<td>Up to 40% (with approval)</td>
</tr>
<tr>
<td>Property development</td>
<td>Prohibited</td>
<td>Up to 25% of deposited property</td>
<td>Up to 10% of deposited property</td>
<td>Prohibited</td>
<td>Prohibited (unless approved by securities commission)</td>
<td>Up to 30% of total assets</td>
<td>Prohibited</td>
<td></td>
</tr>
<tr>
<td>Gearing limit</td>
<td>No</td>
<td>45% of total asset value</td>
<td>45% of total asset value</td>
<td>35% of total assets</td>
<td>35% of total assets</td>
<td>No gearing for investment purpose</td>
<td>35% of total assets</td>
<td></td>
</tr>
<tr>
<td>Minimum distribution requirement</td>
<td>90% of taxable income (post depreciation)</td>
<td>90% of taxable income (no depreciation)</td>
<td>90% of net income after tax</td>
<td>90% of taxable income (post depreciation)</td>
<td>90% of net profit</td>
<td>90% of net profit</td>
<td>90% of net profit</td>
<td></td>
</tr>
<tr>
<td>Tax transparency</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Tax concession for investors</td>
<td>No</td>
<td>10% withholding tax for non-resident companies until March, 2020</td>
<td>No</td>
<td>Final withholding tax of 6%</td>
<td>Yes, final withholding tax of 10% for non-resident individuals and companies</td>
<td>Yes</td>
<td>No</td>
<td>Residents exempt from 10% withholding tax for 7 years, 10% withholding tax for foreign corporates</td>
</tr>
</tbody>
</table>


a K-REITs.
b Unless the REIT intends to hold such property post completion and provided that contract value/investment in such property development does not exceed 10% of property deposited.
c May exceed gearing cap if the REIT obtains and discloses a credit rating from a major rating agency.
d Tax exemption at REIT level only applicable for distributed income to resident unit-holders.
4. Gearing: Japan does not put a limit on gearing, while South Korea does not permit gearing for investment purposes. Other countries permit gearing subject to caps ranging from 35 to 50 per cent. Taiwan, Thailand and the Philippines have a 35 per cent limit, but REITs may borrow more if the REIT obtains and discloses a credit rating from a major rating agency. Singapore REITs had a similar framework prior to 2015, but now have a fixed 45 per cent cap.

5. Distribution: most REIT legislations in Asia maintain a minimum distribution of 90 per cent of net income. However, the basis for deriving the net income available for distribution differs from country to country.

6. Tax transparency and tax concessions for investors: most countries allow for tax transparency. Singapore, Malaysia, Thailand and Philippines provide tax concessions for investors.

In earlier years, some countries gradually relaxed restrictions to make their REIT markets competitive with aspirations of becoming a regional hub. Hong Kong, for example, has revised its REIT guidelines to incorporate the tax transparency provision to boost investor demand for REITs. Singapore and Malaysia have increased the gearing limit to 60 per cent (for rated REITs) and 50 per cent, respectively, from 35 per cent in earlier guidelines. Since the Global Financial Crisis, many countries have refined their legislations and guidelines better to protect investor interests.

Summary and conclusion

Despite the attempts of international authorities to harmonise it, regulation varies around the world. Regulation also applies differently to different entities: publicly traded companies are treated differently from private entities, REITs receive differential tax treatment (and therefore different regulatory treatment) from other entities, debt is treated differently from equity, banks are treated differently from insurance companies. These issues are important to businesses trying to determine how to finance real estate investments, as differences in regulatory treatment create opportunities for regulatory arbitrage. As this chapter shows, there is more uniform regulation in Europe than Asia, in large part because of the existence of the EU (even with Brexit, the UK may wish largely to conform to European regulations so as to continue to participate in that market). Asia, on the other hand, has wide variation in regulatory regimes, at least in part because of differences in levels of financial market sophistication in various countries.

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Notes

1 Higher costs in terms of a monetary valuation of direct and indirect expenses, such effort, resources, time, material and external services to fulfil the requirements.

2 As the institution representing the interests of the European Union, the Commission has the right of initiative to propose new legislation within the legislative process of the EU. The European Parliament, which is directly elected by all European citizens and bears responsibilities for
legislation, supervision and budgeting, then proposes amendments, and finally approves or rejects the legislative proposal. The Council of the EU, representing the member states’ governments and consisting of national ministers who meet according to the topic at hand, also has to approve new legislation and to coordinate policies. The Council of the EU has to take the Parliament’s opinion into account before taking a decision. After new legislation has been implemented, the European Commission ensures that EU law is being correctly applied by the EU member states.

For example, Norway and Switzerland are among these countries. The Swiss financial industry is Europe’s most important sector and follows international regulations such as the Basel Accords. However, it also diverges in some regulatory aspects to attract foreign investors and investment vehicles.

In 1992, Basel I started within the Group of Ten (G10) and was expanded to the Group of Twenty (G20) for Basel III.

Financial institutions that have a leverage ratio exposure measure above €200 billion and are potentially systemically relevant.

On 16 March 2016, the European Central Bank set the interest rate on the main refinancing operations (central rate) at 0 per cent; its rate on the deposit facility, which banks may use to make overnight deposits with the Euro system, has even been at a negative level since 11 June 2014.

So far, the leverage ratio has been only reported to supervisory authorities.

As of March 2018, all member states except Spain had already implemented the MCD (Directive 2014/17/EU). All had to transpose the regulations into their national law by 21 March 2016. This means that even if the EU directive is originally from 2014, national implementation of the binding rules for credit intermediaries had often not been finalised, giving them only a short period within which they can integrate the rules into their business model and business process.

Several of the EU member states had required a longer period to transpose the AIFMD into national legislation.

For a more detailed description of potential extension of the AIFMD passport to non-EU countries, see European Securities and Markets Authority (2016).

Statements are based on survey data and analysis by Deloitte in 2012; see Opp and Hartwell (2012, 4).

See Nareit (2016); US$960 billion; exchange rate from 1 January 2016 of €1 to US$1.0866.


According to the Netherlands tax law, a REIT is required to distribute all of its taxable profit to its shareholders. The possibility of depreciation on passively held real estate to calculate the taxable profit was abolished in 2008. The net balance of unrealised capital gains on securities and realised capital gains on all other investments is excluded from the taxable profit and is, therefore, not subject to the distribution obligation (allocation of a tax-free reserve). See European Public Real Estate Association (2009, 5).

The average leverage ratio of Spanish REITs currently amounts to roughly 50 per cent. This is a further indication that even without a legal defined cap, most REITs keep their leverage ratio at common ratios to avoid a poor assessment by analysts or by the stock market in general.

10% × (0% + 1%) = 0.1%

CR-REIT has a finite life. As of June 2008, three CR-REITs have been liquidated and delisted from the stock exchange: Kyobo-Meritz 1 CR-REIT, KOCREF 1 and Realty Korea 1 CR-REIT. Subsequent to CR-REITs, South Korea developed regular REITs known as K-REITs.

Academic studies generally support the diversification benefits gain from the inclusion of equity REIT into a mixed assets portfolio comprising of stocks and bonds (Geltner et al., 2007).

Yield plays in Japan’s REIT (J-REIT) market were eroded recently when compared with countries like South Korea and Malaysia, which offering higher yield spread than J-REIT in 2007 (Ernst & Young, 2007). One of the reasons is the increase in competitive among J-REIT for a limited supply of quality properties. While J-REIT is allowed to make their investment overseas, no acquisition has been made so far, owing to the ambiguity of overseas acquisition requirement (CBRE, 2008).
Academic research on US REIT documented that the internally managed stock and operating performance of REITs is better than that of externally managed REITs (Capozza and Seguin, 1998; Ambrose and Linneman, 2001).

Hsieh and Sirman (1991) argue that captive REITs tend to invite sponsor–shareholder conflict with the sponsor capitalizing on the REIT vehicle to support their financing needs.

There are six cross-border Singapore REITs backed by foreign assets: Allco Commercial REIT, Ascott Residence Trust, CDL Hospitality Trusts, CapitalRetail China Trust, Fortune REIT and First REIT.

References


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Geltner (2007)  
Hsieh and Sirman (1991)  


