Andreas Dombret: An overview of the CRE (Commercial Real Estate) market

Contribution by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, as Lead Discussant at the FSB (Financial Stability Board) Workshop on Commercial Real Estate Underwriting, Frankfurt am Main, 8 May 2013.

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Ladies and gentlemen

I am delighted to welcome you to the FSB workshop on commercial real estate underwriting practices on behalf of the Deutsche Bundesbank. We are very happy to host this important FSB event here in Frankfurt.

I am very pleased that so many dedicated real estate experts from a variety of FSB member countries and institutions, from standard setting bodies and from the private sector participate today. I am sure that the gathered expertise will lead to fruitful discussions and provide for interesting insights.

Let me now start this session by sharing my views on global commercial real estate financing. I will touch on two issues in the following minutes: first its relevance for banks and other participants in the financial markets and second its implications for financial stability.

One of the reasons for the financial crisis was the US sub-prime crisis caused by lax lending practices and overheating residential real estate markets. The FSB has completed considerable work in this area, which mounted in FSB Principles on Sound Residential Mortgage Underwriting Practices. The question about the other and perhaps even more important part of the real estate lending business will be dealt with in this workshop: Could excessive risks from commercial real estate financing negatively affect financial stability? (slide)

The global stock of commercial real estate is estimated at 31.2 trillion U.S. dollars as of 2011. About two thirds of global total stock is considered to be investable. The majority of investable stock is already invested and accounts for more than 12 trillion U.S. dollars. This part is in the primary focus of this workshop. Taking into account the market share of commercial banks it is not surprising that for example European banks have an estimated total CRE lending exposure of 2.4 trillion Euros. But let me stick to the CRE markets for a few more moments before I will turn to the lenders and banks. (slide)

Since 2007 we have seen a divergent development of CRE prices among the G20 countries. South Africa, Canada and Korea are the only countries that show an increase of CRE prices since 2007. Contrary to them most other countries suffer from a more or less strong deterioration of CRE prices. Just to name a few: U.S. –19%, UK –23%, Spain –29% and Ireland –67% between 2007 and 2012. Recently, there are signs of stabilisation or even an upward trend. However, a rapid rebound of CRE prices in most G20 countries to a pre-crisis level seems unlikely in the short-term.

If I look at the development of prices and the annual investment activity at once I can see certain coherence between the two. (slide)

While global invested volumes fell by two thirds from 2007 to 2009, they almost doubled after that in only two years to almost 400 billion U.S. dollars. Unsurprisingly, invested volumes for Asia-Pacific have gained tremendous market share over the last few years and are now at the same level as for Europe and twice as high as for North America. (slide)

Having the pleasure of welcoming all of you here in Frankfurt – Germany's banking city – I would like to take the opportunity to briefly give you some insights into the German CRE market. Germany has seen a moderate development of CRE prices over the last decade.

However, the CRE market and consequently CRE prices – unlike most other European markets – have benefited from the economic conditions here. Foreign investors have stepped up their investment activity over the past two years.

Leaving Germany and taking a global view again the question is, what is the state lenders and investors are in? (slide)

Obviously, falling prices have not failed to leave a mark on both. An enormous half of investors in EMEA and 75 percent in North America are in talks with banks on loan amendments and/or loan extensions. If restructuring or extension of the loan is not possible, investors must find other sources of capital for equity injections or partial loan repayments and if this fails even asset sales are on the agenda. Clearly challenging times for investors and following them, the lenders. (slide)

The latter have chosen a very selective path in financing CRE, lately. A more cautious underwriting practice and tighter lending standards can be observed. According to the survey of lenders for DTZ' global research, a preference for less risky investments was identified. Prime assets are in favour of lenders, whereas speculative developments and non-prime assets are currently not part of their strategic agenda. This trend of consolidation is also reflected in new lending, where only a minority of survey respondents expected expansion of business in 2012, while more than a third wanted to reduce CRE lending. In addition, underwriting terms and conditions were expected to further tighten in 2012. However, for 2013 lenders expect some relaxation of lending practices back to rather normal levels, which can be interpreted as a positive sign.

Now, let me draw your attention to an important aspect of CRE financing – the CMBS markets. (slide)

We have seen deteriorated CRE prices, selective lending practices, and investors being in talks about workout with their lenders. Based on this the future does not look promising from the point of view of financial stability. If we look at maturity dates for CMBS, there are 40 to 50 billion U.S. dollars a year to be refinanced globally until 2020. The U.S. accounts for the majority of these maturing CMBS. However, the remaining countries, among them the U.K., Germany and Japan are most important, account for the other half of maturing CMBS until 2020.

Numerous times the question about a funding gap was raised. For Europe alone, DTZ Research looked beyond CMBS and identified a funding gap for all commercial real estate for the years 2012 to 2014 that exceeds 100 billion U.S. dollars.

So, who is going to fill the gap? (slide)

In Europe and the U.S. more than half of CRE financing is provided by commercial banks. Insurers account for more than 10 percent in both regions. In the U.S., ABS issuers gained importance over the last 20 years and account for more than 20 percent of the market today, according to the Federal Reserve. CRE financing markets can be described as fragmented, but they are still dominated by the banking sector. The current weakness of the banking sector calls for non-bank financiers such as insurers and pension funds. Moreover, the impact of regulatory initiatives such as Basel III and banks' need to deleverage will affect CRE lending. Weak securitisation markets put additional pressure on CRE markets.

Although banks are the most important providers of finance to the CRE market, CRE loans only account for 10 to 15 percent of the loan book globally. Although individual shares may differ greatly, certain trends can be observed. In the U.S., CRE loans add up to more than 20 percent of banks' loan portfolios while for example in German banks they only account for 7 percent on average. However, the range for German banks varies and can be as low as 2 but also as high as 25 percent for an individual bank. (slide)

In conclusion, let me highlight the key aspects I would like to see considered in the context of commercial real estate financing. You have seen, that CRE tends to be more volatile.

Moreover, global and adverse economic developments usually have stronger impacts on CRE markets and financing compared to its relative, the residential real estate market. CRE financing is clearly a global business that accounts for a considerable part of banks' assets. As highlighted before, the CRE market attracts multiple lenders with different backgrounds. And they have a multitude of finance tools in their hands. It is not surprising that CRE finance is rather complex and differs even more among countries compared to the residential equivalent. All this contributes to limited availability, quality and comparability of data on CRE financing and markets. (slide)

This workshop aims at the importance of CRE underwriting and its role in financial stability. There are numerous aspects and implications to discuss over the next few hours. And hopefully, there are first conclusions being drawn and questions being answered. For example: In what way may CRE cycles and potential asset price bubbles affect CRE underwriting and financial stability? To what extent would the deterioration of CRE-related asset quality and values affect banks' balance sheets? Does banks' forbearance play an important role? What would be the effect of further loan losses and break away of profits, which relate to CRE lending? What are the dynamics and dependencies between investors, different types of lenders, market developments, and economic prospects? And last but not least: From a regulator's perspective – and as a possible issue for discussion during the afternoon sessions –, do we have all relevant information and tools at our discretion to identify CRE related risks and to manage or even limit those to an acceptable level?

A stable financial system is essential. CRE underwriting plays an important role in this. Appropriate information and instruments now need to be identified and if seen as necessary should be implemented subsequently. This workshop and all your contributions will help to take the right steps towards safer banks and a better financial system. As a central banker, I am therefore particularly happy that my fellow lead discussants in this session all are from the private sector. And I look forward to your contributions.

Thank you very much for your attention.

The size and structure of the global CRE market
- Global CRE stock accounts for more than USD 30 trillion -

- USD 31.2 tn in global CRE invested stock
  - invested stock: 12.1 tn
  - investable stock: 7.8 tn
  - non-investable stock: 11.2 tn
- Total CRE lending exposure of European banks estimated at EUR 2.4 tn*

Source: DTZ Money into Property Global.
Deutsche Bundesbank

*according to calculations by MorganStanley

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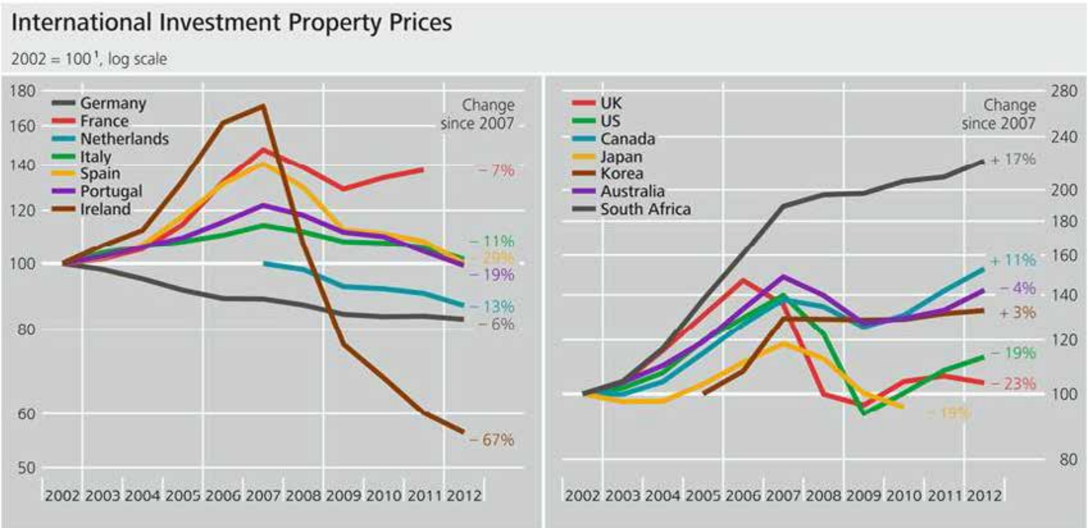
The size and structure of the global CRE market
- Deterioration of CRE prices since 2007 in most countries -



Source: Bloomberg (IPD) and Bundesbank calculations. **1** Indexation for Korea and the Netherlands starts with data availability in 2005/2007. End-of-year values 2012 for the US and Australia are calculated on the basis of quarterly growth rates.
Deutsche Bundesbank

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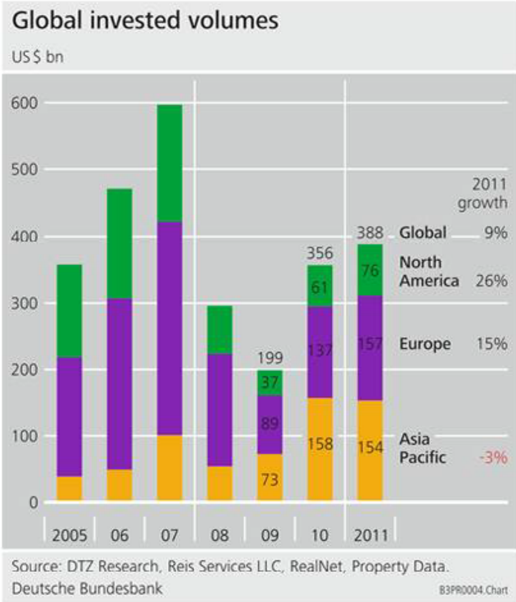
The size and structure of the global CRE market
- Structural shifts -

- Global invested volumes down from USD 600 to 200 bn between 2007 and 2009
- Global volumes in 2011 at pre-crises level of 2005, but North America still at half of 2005
- Strong growth of Asia-Pacific



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The size and structure of the German CRE market
- Economic conditions support Germany's CRE market -

- German CRE prices benefit from current favourable economic environment
- Foreign investors have stepped up activity in German CRE market especially over the past two years, partially due to previously moderate development of CRE prices
- Market value CRE, 2011*
  - Residential: € 2,400 bn
  - Industry & Logistics: € 1,100 bn
  - Office: € 715 bn
  - Retail: € 410 bn

*BulwienGesa AG and Bundesbank calculations

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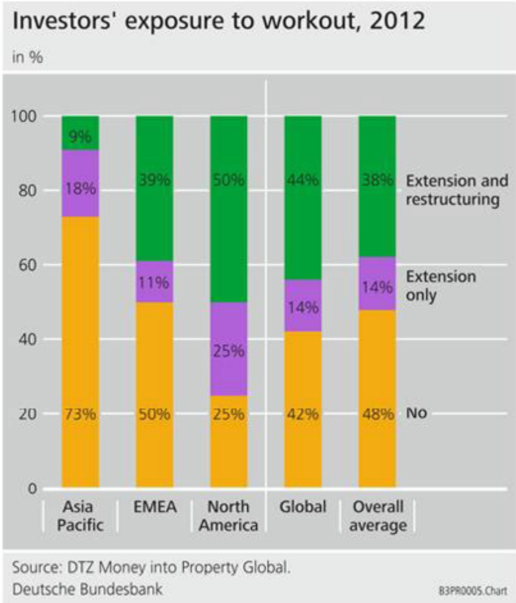
The importance of CRE lending to the banking sector
- A challenging environment for investors and lenders -

- Half of investors in EMEA and 75% in North America are in talks with banks on loan amendments and/or extensions.
- Asia-Pacific proves to be considerably stronger.



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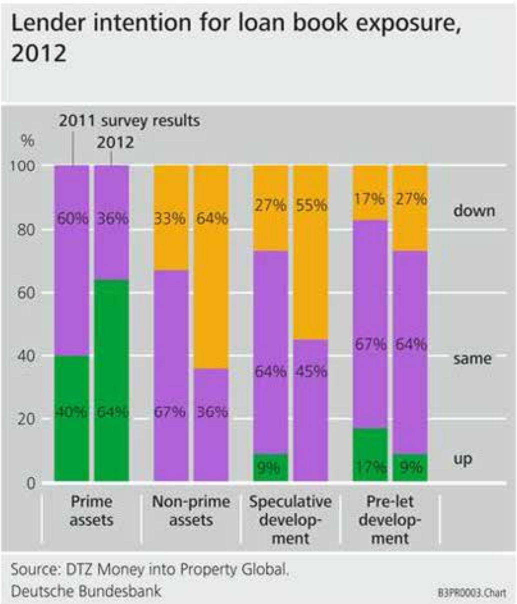
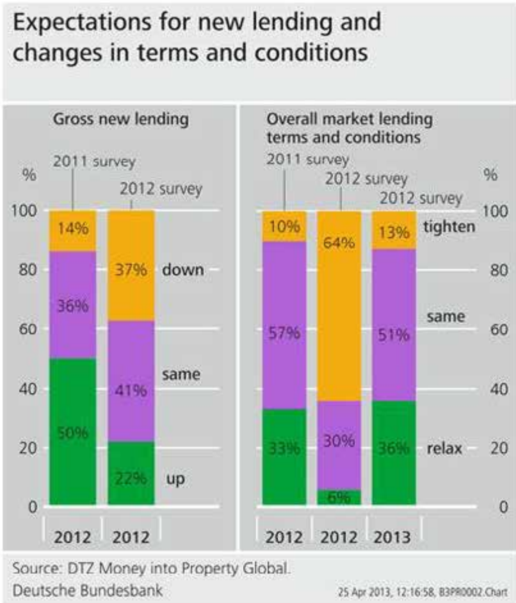
The importance of CRE lending to the banking sector
- Banks‘ de-risking strategies -





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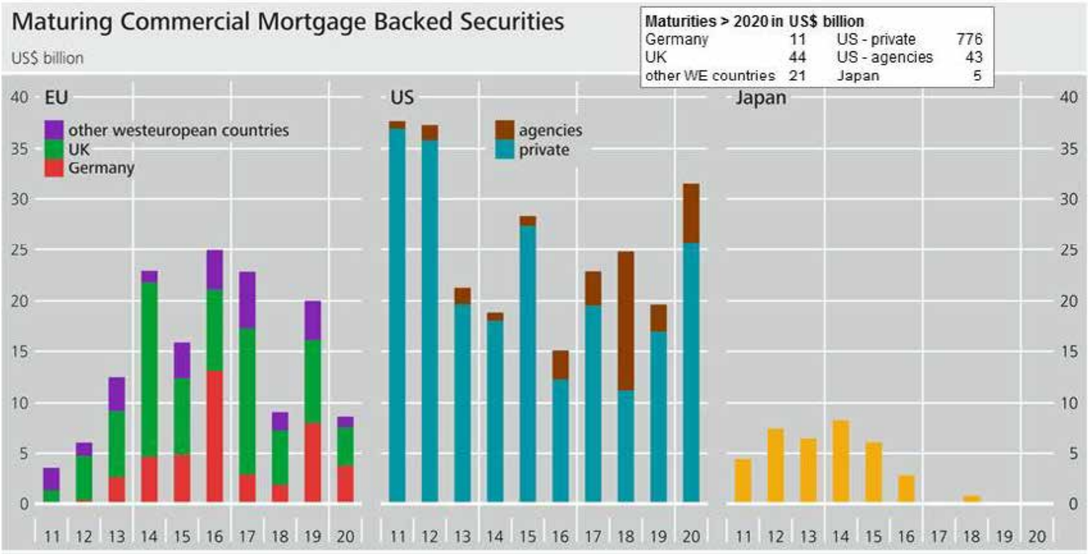
Non-bank investors and credit providers in CRE lending

- CMBS' contributions to a potential funding gap -



Source: Dealogic and Bundesbank calculations. Securitisations retained by the issuers are not included.
Deutsche Bundesbank

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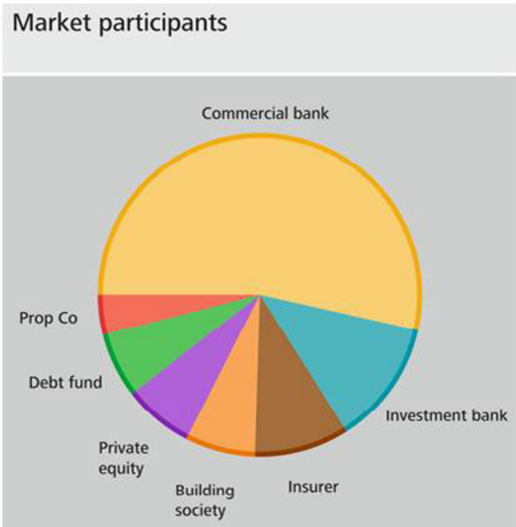
Non-bank investors and credit providers in CRE lending

- Commercial banks only account for half of the market -

- Increasing market share of non-bank financers (e.g. insurers, pensions funds)
- Impact of current regulatory initiatives (e.g. Basel III) expected – banks' deleveraging affects CRE financing
- Share of CRE loans in banks' portfolios differs greatly*:
  - Global average: 10 – 15%
  - US: > 20%
  - Germany: 7%



Sources: Cushman & Wakefield, European Real Estate Lending Survey, March 2012.
Deutsche Bundesbank

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Sources: EBA Stress test 2011, DB Research, Deutsche Bundesbank

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Current topics, trends, and challenges: issues to discuss
- Risk drivers and information gaps -

Current status

- CRE lending represents **considerable part of banks' assets** and tends to be more volatile
- Stronger impact of adverse **economic developments** on CRE markets and financing compared to residential mortgages
- **Global financing for local CRE** projects and markets with far-reaching systemic impacts
- **High complexity** due to multiple market participants and financing tools
- Availability, quality and comparability of **data on CRE** financing and markets differ greatly
- Limited availability of tools for the **identification of (potential) risks** from CRE financing

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Current topics, trends, and challenges: issues to discuss
- The relevance of CRE underwriting for financial stability -

Financial stability implications from CRE markets/lending

- **CRE cycles and potential asset price bubbles** in the context of CRE underwriting and financial stability?
- Deterioration of **asset quality and values**? Negative **forbearance** on CRE exposures?
- Decline in **CRE lending-related income** for banks (further loan losses and break away of profits)?
- Dependence of CRE investors on certain **funding sources**?
- **Funding gaps** due to short duration of loan agreements and bullet redemption?
- **Concentration risk** associated with CRE lending?

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