IPF Research Programme

The Changing Sources of Real Estate Debt Capital: Facts and Implications

MAY 2017

SUMMARY REPORT

This research was commissioned by the IPF Research Programme **2015 – 2018**

This research was funded and commissioned through the IPF Research Programme 2015–2018.

This Programme supports the IPF's wider goals of enhancing the understanding and efficiency of property as an investment. The initiative provides the UK property investment market with the ability to deliver substantial, objective and high-quality analysis on a structured basis. It encourages the whole industry to engage with other financial markets, the wider business community and government on a range of complementary issues.

The Programme is funded by a cross-section of businesses, representing key market participants. The IPF gratefully acknowledges the support of these contributing organisations:

Changing Sources of Real Estate Debt Capital: Facts and Implications

Report

IPF Research Programme 2015–2018

May 2017

Research Team

Hans Vrensen, *Hans Vrensen Consulting Limited*
Nicole Lux, *Consultant*
Neil Blake, *CBRE*

Project Steering Group

Rob Martin, *LGIM Real Assets*
Matthew Bennett, *Wells Fargo Bank International*
Anne Breen, *Standard Life Investments*
Richard Day, *Deutsche Asset Management*
Christian Janssen, *TH Real Estate*

Acknowledgements

The authors thank PwC and Clifford Chance for their assistance. Other data sources, including BAML, Trepp, Cushman & Wakefield, Dealogic, Green Street Advisors, INREV, IREBS, Bloomberg, Moody's Investor Service, Mortgage Banking Association and De Montfort University, are acknowledged throughout to recognise their contributions.

Overview

Commercial real estate (CRE) investors have traditionally used debt to enhance their equity returns and increase the size and diversity of their portfolios. CRE plays an important role in the overall UK economy, as implied by the c. £870 bn market value, representing some 10% of national net wealth, as at the end of 2015. During the Global Financial Crisis (GFC) of 2008–2009, however, declining CRE values resulted in large debt and equity losses, as property value declines triggered loan defaults and collateral enforcements.

Since the GFC, the UK has become the most diversely sourced CRE lending market in Europe. This is evidenced by insurers and other non-bank lenders originating 25% of all 2015 CRE loans and a further 15% through bond issuance. With a quarter of all UK CRE loans being syndicated, originating banks are reducing their CRE loan exposures by selling down to other banks and non-bank lenders. Evidence collected from individual interviews suggests that syndication has increased the combined insurer and debt fund share of annual loan origination from 25% to 35%. Despite these structural changes, banks retained a 60% share of 2015 loan originations, with the six largest UK banks still holding a 40% of new lending. The emergence of increased lender diversity supports more stable annual loan origination volumes reinforcing the consistency of debt capital availability to CRE investors over time.

Regulatory change has been the key driver of greater diversification in the UK CRE lending market. Primarily, new regulations have been triggered to avoid future bank failures, government bailouts and takeovers, such as occurred during the GFC, being partly caused by losses on CRE loan books. One of the key findings of this study is that cumulative CRE loan losses for European banks amounted to between 9.5% and 12.5% of original loan balances, exceeding losses on securitised CRE loans (at c. 3%). Given this performance record, diversification away from banks (as the single dominant CRE lending source) makes sense, especially from a financial market stability perspective. Tighter rules set by central banks and other regulators, forcing banks and other lenders to increase their capital reserves for CRE loans, have improved financial stability. Regulation is the central theme in this analysis of the increase in CRE lender diversification.

CRE investors have benefited from this diversification, as loan margins in the UK have fallen in recent years and are now reported by CBRE to be among the lowest in Europe. However, a wider range around the declining average UK loan margin has also emerged, as different lender types have focused on various margin-risk segments of the lending market. Again, this is tied to new regulations with different CRE lender types impacted differently. Inconsistent implementation of some international rules across countries also remains, with UK banks facing stricter slotting rules than banks elsewhere.

There is a direct impact from regulations on the ability of each lender type to take risk and price loans, based on the researchers' analysis of the slotting, Basel III and IV and Solvency II rules. Regulation and lender business models have changed the segmentation across the risk-return spectrum as well as loan type and size. Regulation directly impacts lenders' loan pricing and risk appetite. The future direction of regulation is not yet clear, but further changes are under discussion.

Due to favourable regulatory treatment, German covered bond-funded banks and insurers have been able to offer the lowest margins in the UK market. This is due to the ability of these Pfandbrief-funded banks to apply the advanced internal rating-based (A-IRB) approach under the Bank for International Settlements Basel Committee on Banking Supervision (or Basel III) rules. A-IRB banks have therefore focused on writing low margin and low risk business, especially as their cover pool (which act as security) eligibility criteria restrict higher LTV loans. However, proposed changes to the Basel rules (IV) might lead to a 80 bp increase – or near doubling – in margins offered by this German lender category. In the case of insurers and insurer-funded senior debt funds, CRE loan pricing is driven by the capital requirements under the Solvency II rules. Insurers are also restricted to lower risk/lower margin loans by Solvency II, leading to both insurers and many German banks focussing on the same segment of the CRE lending market.

As a result of the introduction of the new slotting rules in 2013–2014, UK banks have been forced to become more conservative in their CRE lending activities. Data from De Montfort University shows UK bank margins widened after the slotting rules came into force. Pension funds and debt funds are able to pursue a broader range of risk-return strategies in real estate lending. This means they are in a position to also fund higher risk/higher margin loans. From a borrower's perspective, it would be wise to actively diversify amongst lender types as future regulatory changes are likely to impact different lenders more or less severely. Regulatory diversification amongst CRE lenders might be a clever objective for borrowers in future.

Improved resilience in future UK capital value cycles compared to past downturns is expected to be another positive effect from the UK's more diversified lender market. This view is supported by the well-diversified nature of the CRE lending market in the United States (US). Record CRE loan origination levels in 2015 pushed US CRE values 14% above their 2006 previous peak by year-end. In contrast, the less diversified UK CRE lending market in the same year reached only 64% of its previous annual origination record in 2007 and UK capital values were still 11% below their 2007 peak by year-end 2015. The US market data implies, therefore, that greater lender type diversification and transparency strengthen the resilience of both the CRE lending and the underlying property markets. Based on this, the authors expect a better diversified lending market in the UK to support a more robust capital value recovery in future market cycles. Evidence from US markets also suggests that insurers are likely be likely long-term competitors in the UK lending market.

Based on the above, it is the researchers' view that, for the foreseeable future, the UK CRE investment and lending markets will continue to see the benefits of increasing diversification of debt capital sources. These benefits include: (1) greater financial market stability; (2) more competitive loan margins; and (3) improved resilience in CRE capital values through economic cycles.

Literature Review

- A variety of analysis of CRE debt has been undertaken by academics, regulators, industry organisations and business researchers, with their focus ranging from long-term systemic property and credit cycle comparisons and reviews of the impact of regulation on CRE lending to more practical implications and statistical default and loss analyses.
- In general, since it has not been obligatory to disclose more granular data on CRE lending in the UK and other European markets, detailed, loan-by-loan data is not available to public or academic research. This is in contrast with the US, where large datasets on CRE loans are made public. However, this is likely to change in the UK, as regulators and industry groups are intent upon increasing transparency in future.

Use of debt in CRE investment

- CRE investors have traditionally been motivated to use debt to enhance their equity returns and increase their capacity to increase the size of their total investments. However, debt can also amplify negative property returns into even larger equity losses.
- The optimum debt level is hard to determine, but evidence from US REITs shows that leverage above 35% adversely affects company returns. Data for European REITs is less conclusive.
- Evidence from INREV and MSCI shows the negative impact of high leverage on total returns for funds after the GFC. This experience in using debt has not been uniformly positive for borrowers.
- UK loan structures have led to greater complexity in post-GFC work-outs.
- US and other markets might have been more resilient in recovering from GFC-related downturns in collateral value due to their longer term, fixed rate and partly amortising loan structures.

Historic development of debt capital sources

- With 40% of debt being originated by insurers and other non-bank lenders, as well as various bond issuances, the UK is the most diversely sourced CRE lending market in Europe, but still less so than the US.
- Covered bonds have proven to be a successful and efficient funding vehicle in use across Europe, giving German banks a dominant position in their domestic market.
- With 25% of all UK and 15% of all European CRE loans syndicated, this is a growing market that appears to have effectively replaced securitisation for the funding of larger loans among more lenders.
- In the UK, syndication appears to increase the market share of insurers and other non-bank lenders, to an estimated 35% of CRE loans while originating 25% of CRE loan volumes in 2015.
- Senior unsecured corporate bond issuance (by REITs and private property companies) has more than doubled since 2010, further filling the gap left by much reduced CMBS issuance.
- But, despite these structural changes in funding, banks remain the single biggest lender category in Europe (at over 68%), leaving it much less diversified than the US, where more than 40% of debt is originated by non-bank lenders.

Risk and return in CRE lending

- When considering the evidence on risk and return for CRE lending margin and loss data are examined. UK data shows that low LTV CRE loan margins have come down from their 2012 peak, while higher LTV loan and junior loan margins remain high.
- German lenders have been able to offer the lowest loan margins for four of the last five years in the UK market. CBRE data shows that UK loan margins are at record lows since 2009 and second lowest in Europe, only behind Germany, driven by low cost covered bond funding.
- The researchers estimate securitisation-funded cumulative CRE loan losses of below 3%. This compares favourably to their estimate for European banks at between 9.5% and 12.5%.
- Despite these losses, the researchers' comparison shows that on a risk adjusted basis CRE lending offers good relative value against other CRE opportunities, increasingly attracting multi asset investors. For low LTV UK CRE loans the Sharpe ratio is three times the IPD All Property index level.
- Lender motivation, business model and structure lead to certain segmentation across the risk-return spectrum as well as loan type and size. Pension funds have a broader range of risk-return strategies in real estate lending. This means they are in a position to also fund higher risk/higher margin loans. This is different from insurers, which are more restricted to lower risk/lower margin loans. This is large part driven by regulatory requirements, discussed below.

Regulatory impact on CRE lending

- A large number of new non-CRE specific regulations have been launched since the GFC, with little coordination amongst different national and sector-specific regulators. These impacted various CRE lender types as well as borrowers differently.
- The Basel framework ruling banks is expected to evolve further in future. Inconsistent implementation of Basel across countries remains, with the UK's central bank implementing strict slotting rules for banks' CRE loans.
- Regulatory treatment across all lender types impacts lenders' ability to competitively price loans based on their cost of capital. Insurers need to comply with Solvency II capital rules, which are requiring similar capital reserves as for German covered bond-funded banks. In the UK market, this has meant that banks able to use the advanced-IRB approach and insurers subject to Solvency II are able to offer loans at lower margins than UK banks and other lenders, which does offer arbitration opportunities to borrowers.
- This means that insurers and German A-IRB-focused banks are focused on lower risk and lower margin lending business, leaving more risky lending to debt funds requiring higher margins. In short, regulation directly impacts loan pricing by 80 bps for A-IRB regulated banks. In particular, Solvency II is keeping insurers and insurer-funded senior debt funds focused on low risk and low margin loans.
- Some progress has been made in meeting the challenges set by the 2014 Vision paper, despite significant regulatory set-backs. However, much more needs to be done to improve transparency and facilitate the sustainability of non-bank lenders in the longer term.
- Asset purchasing programmes by central banks, as part of their quantitative easing policies, have only benefited certain asset types.
- Quantitative easing has not yet had the expected positive impact on economic and job growth. But, CRE has become better relative value for multi-asset investors as bo`nd yields tighten. The Brexit vote has increased uncertainty on many fronts.

Implications of increased CRE lending diversification

- A comparison between the UK and US shows that UK All Property capital values at year-end 2015 were still 11% below their previous cycle peak, in contrast to the US being 14% ahead of their previous year-end 2006 peak.
- The US market data implies that greater lender type diversification and transparency strengthens the resilience of both the CRE lending and the underlying property markets. Therefore, going forward the researchers expect a better diversified lending market in the UK to support a more robust capital value recovery in future market cycles.
- A crucial impact of tighter bank regulation is the emergence of increased lender diversity, which supports more stable annual origination volumes. This stability of debt funding reinforces the consistency of capital availability to the borrowers in the investment market.
- As lender diversity has increased in the UK in recent years, it has also led to lower average loan margins. However, a wider range around this declining average loan margin also emerged due to the larger number of different types of lender competing in the market.
- This wider range of loan margins in the market is in part explained by different lender types focusing on various risk segments of the market. As mentioned before, insurers and senior debt funds are more focused on low-margin and low-risk loans.
- With the potential introduction of Basel IV rules, the remaining A-IRB banks (including German Pfandbrief-funded banks) will no longer be able to get favourable capital treatment for their CRE loans. This has the potential to limit their ability to provide low margin loans. This is another example of regulatory changes directly impacting on CRE loan pricing. This further supports the view that regulation drives loan pricing.
- From a borrower’s perspective, it would be wise to actively diversify amongst lender types as future regulatory changes might more or less severely impact different lender types. Regulatory diversification might be a clever objective in its own right.

NOTES

Changing Sources of Real Estate Debt Capital: Facts and Implications

Research

Investment Property Forum
New Broad Street House
35 New Broad Street
London EC2M 1NH

Telephone: 020 7194 7920
Fax: 020 7194 7921
Email: ipfoffice@ipf.org.uk
Web: www.ipf.org.uk

Printed on recycled paper