Commercial property and financial stability - is the system more resilient to a shock now?

- Capital values have risen nearly 60% since 2009 even though banks have continued to deleverage
- Commercial real estate lending has become more diversified with non-bank lenders filling the gap
- Overseas investment has been a dominant driver of capital value growth and has its own risks attached

Introduction

Episodes of distress within commercial property markets carry significant repercussions for financial stability. Falls in asset values impair banks and other lenders' balance sheets, thereby exacerbating economic downturns and restricting credit provision. Taking the most recent financial crisis in the UK as an example; a sharp rise in debt linked to commercial real estate (CRE) investments leading up to the recession contributed to rapid price growth of such assets. The subsequent decline in values triggered an increase in the number of non-performing loans and defaults. Banks were then left nursing hefty losses, with the heightened sense of lender caution only acting to further depress activity across the economy.

Since then, notwithstanding a brief spell of falling capital values immediately after the Brexit vote, commercial property prices have rebounded firmly. According to CBRE estimates, UK commercial property capital values have risen 57% since their 2009 low point. That said, values, at least in terms of the all-property and national average, have not yet retraced all ground lost after the global financial crisis, still sitting 10% below the peak set in 2007.

Across some regions and sectors of the UK market however, most notably in London, commercial property is trading at yields well below the averages seen pre-crisis. As a result, concerns over current valuations are more evident in these localities. Indeed, a majority of RICS UK Commercial Property Survey respondents now view the London market as being above fair value, while the proportion is also rising elsewhere (chart 1). This could be an indication of repeated over-exuberance, at least in part, by investors, which may in turn leave real estate vulnerable to a sharp correction once again. It would seem prudent, then, to monitor the current level of exposure to commercial property within the financial system and observe how this has changed throughout the current cycle.

Warnings from the previous cycle

In the five years directly preceding the 2008 financial crisis, bank lending to the commercial property sector (in terms of amounts outstanding) increased by 149%. In fact, the total stock of debt owed by companies undertaking the buying, selling, renting or construction of CRE increased by more than a third between the beginning of 2007 and the end of 2008 alone. Come the end of 2008, loans to the sector made up 12% of the total stock of debt across the economy (chart 2). At its peak, CRE debt equalled over 16% of annual Gross Domestic Product.

Alongside the accumulation of debt, annual investment volumes into the UK commercial property market trebled, increasing from £21bn in 2000, to £67bn in 2007. This rise in market activity pushed capital values up 49% over the space of 5 years. Given commercial property valuations then fell by 43% from peak to trough over the next two years, it is little surprise that serious pressures began to emerge for lenders (chart 3).
While property prices were still rising, losses on commercial real estate lending were close to zero. But, when the downturn struck, loan performance deteriorated dramatically. Bank of England figures show the rate of loan write-offs increased sharply between 2008 and 2012, with their estimates pointing to around 6% of the total stock of CRE debt being written down during that time. However, some banks performed much worse than that figure would suggest. The poorest performing large UK bank, again according to the Bank of England, needed to write-off 20% of its CRE loans. Moreover, research from the Financial Services Authority found that in 2011 around one-third of the outstanding stock of commercial property debt was in some form of forbearance, while many other loans were at least in negative equity.

Crucially, the troubles are amplified as lenders have somewhat limited protection when it comes to using commercial property as collateral. If the lender only has a claim to the underlying property, and debt repayments cannot be made from rental income, then the borrower may choose to default instead of injecting their own capital. At that point, the lender is likely to become the owner of an asset which has significantly depreciated in value (in many instances to less than the original loan value) with poor rental income prospects. The risks are perhaps even greater when it comes to lending for development. Given the lags involved in completing construction projects, units often become available after the downturn is underway, leaving many schemes unprofitable as well as further adding to the rise in vacancy rates associated with a deteriorating market.

This goes to illustrate the inherent risks involved with lending to commercial property and why the sector has played such a key role in past financial crisis.

Is the current cycle different?

Although capital values have appreciated significantly over the past five years as a whole (35% since 2013), this phase of the cycle has not been accompanied by an increase in bank loans. In fact, net lending to commercial property has been negative to the tune of £40bn cumulatively since 2009 (chart 4). This has brought CRE’s share of total debt down from a peak of 12% in 2008, to 6.8% currently, the lowest proportion since 2001. This may seem unusual given investment into the sector has surpassed levels found prior to the global financial crisis by some margin. Chart 5 shows that, on a twelve month rolling basis, the sum of investment volumes into the UK commercial property market hit a high of £77bn in 2015, compared to the £67bn high watermark previously set in 2007.

Breaking the investment data down by source reveals a significant shift in composition between the pre and post crisis periods. Most strikingly, overseas investment has on average accounted for nearly 45% of quarterly volumes since 2011, up from 25% in the seven years preceding the crash. Set against this, private property companies have averaged a share of 12% in the past seven years, down 22% previously. The decline is also evident across the private individual category, with this
proportion down from nearly 10% to less than 5% on the same basis (chart 6).

This goes some way to explaining why UK bank lending to the sector has fallen in net terms even though investment volumes have risen fairly sharply. It also suggests, where overseas investment funds were originating crowdf from outside the UK, that any shift in the market will have a smaller impact on domestic financial institutions than in the past. However, it does not mean a drop in commercial property asset prices will be inconsequential for domestic financial conditions. Small and medium sized companies still commonly use CRE as collateral. Therefore, even if domestic banks avoided incurring such hefty losses during a downturn this time around, credit flows to the corporate sector could still be hindered as the company’s assets (which are borrowed against) will have depreciated in the value. Indeed, research conducted by the BoE estimates a 10% decline in UK commercial property prices can be linked with a 1% fall in investment across the UK economy. Nevertheless, banks have clearly decreased exposure to the sector and this should at least ensure their balance sheets remain in better shape than in previous cycles.

Changes in the regulatory environment offer another explanation behind the trend seen in bank lending to CRE. Due to the losses suffered during the global financial crisis, tighter rules on the level of capital reserves banks are required to set aside for CRE loans were introduced, and this has likely been a constraining factor. However these changes do not apply to some institutions, meaning other lender types have increased their share to fill part of the void. As such, these changes having driven commercial real estate lending to become more diversified overall.

According to the De Montford Commercial Property Lending Report, UK banks and building societies originated close to 70% of UK commercial property mortgages in 2007, with this proportion having remained more or less stable throughout the decade before. Interestingly, this share has shrunk to leave less than 50% of CRE mortgages being accounted for by domestic banks over the past three years. At the same time, UK insurers have increased their CRE lending activity significantly, representing 10% of loan origination over the same timeframe. Prior to the crash, such lenders were almost non-existent, at least in terms of market share. Meanwhile, other non-bank lenders have increased market share considerably since 2011, representing 14% last year. Taken together, insurance companies and other non bank lenders now account for a combined 23% of the total stock of outstanding debt in the sector.

Generally speaking, moving away from a situation where banks are such a dominant source of CRE lending could help mitigate some of the dangers from a financial stability perspective, as risks are no longer concentrated in a single area. That should then reduce, to some degree, the restrictive impact on credit availability during a downturn in the market and lessen the subsequent fallout across the economy more generally.

That said, it should be highlighted that although lending by insurers is supervised through solvency regulations, other non-bank lenders face no such restrictions. This means the activity of private debts funds, for example, is driven predominantly by the level of returns sought by investors and will typically be targeted at higher yielding assets. Lending of this nature clearly carries greater risk. Even so, the impact of any CRE loan defaults or losses from non-bank lenders on financial stability is likely to be limited given their still relatively small market share. The rate at which non-bank institutions have stepped up lending in response to the ongoing CRE deleveraging by banks has been fairly sharp up to this point, however. If this process were to continue, with unregulated lenders building further market share, this would then pose more of a danger and should be monitored closely. For now, though, greater diversification in CRE lending should be viewed as a relatively positive outcome.

In keeping with this, the largest share of respondents to the RICS UK Commercial Property Market Survey (36%) sense that the current composition of UK real
estate investment flows makes the market less vulnerable to a severe downturn compared with pre-2008. Only 9% felt the market is more vulnerable as a result, although 35% sense there has been little change (chart 7).

In its 2018 annual stress test of the UK banking system, the BoE estimates that a 40% fall in UK commercial real estate prices would now lead to an impairment rate half of that which prevailed during the financial crisis. This better performance is attributed to banks having tightened underwriting standards, reduced loan book size, and improved the overall quality of their CRE linked assets. In evidence of tighter underwriting standards, the stock of CRE mortgages advanced at a loan to value ratio of more than 70% has fallen from nearly two-thirds in 2012 to just 10% currently. It would therefore appear that greater regulation around lending within the sector has improved the resilience of the financial system to a shock in the CRE market through a number of avenues. The usage of leverage has decreased, lending has become more diversified and increased capital requirements have put balance sheets in a healthier position to be able to deal with a sharp pullback in prices.

The views of RICS survey contributors, on balance, give some support to this idea, with 46% stating that they feel regulatory changes following the GFC have made the UK financial system more resilient to potential shocks in the commercial property market (compared to just 23% who feel they have not). Admittedly, a significant proportion of 34% were unsure (chart 8). While it remains to be seen just how effective in practice the new regulatory framework will be at containing any potential fallout from a contractionary phase of the property cycle, feedback appears broadly positive on the steps taken.

**Conclusion**

It seems the financial pain caused by the 2008 crisis has induced some meaningful structural changes across the commercial property market. The approach taken by banks has been altered in the face of tighter regulations, with the composition of lenders in the market changing noticeably as a result. It would appear this broadening out in loan origination and debt across different lender types has lowered the risks to the financial system that would be associated with a CRE correction. Indeed, the recent period of capital value growth has not been driven by a build-up in debt, as banks have continued to deleverage during this time.

Even once non-bank lending activity is accounted for, total CRE debt is comfortably lower than in 2008. The rise in valuations this time around has largely been underpinned by overseas investment instead. Ultra-loose monetary policy globally has likely contributed to this trend and may leave the market more vulnerable to a switch in appetite from foreign investors than in the past. On the back of this, the reversal of quantitative easing programmes from the world’s largest central banks could be a significant influence further down the line. Although a severe market downturn would invariably still carry some negative knock on effects for domestic financial conditions, the measures put in place since the GFC should help to mitigate the effects to a greater degree.
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