Commercial Real Estate Debt in the European Economy **2016**

> supports growth and sustainability in the EU
> source of secure income for institutional investors
> more diverse lending sources post-GFC

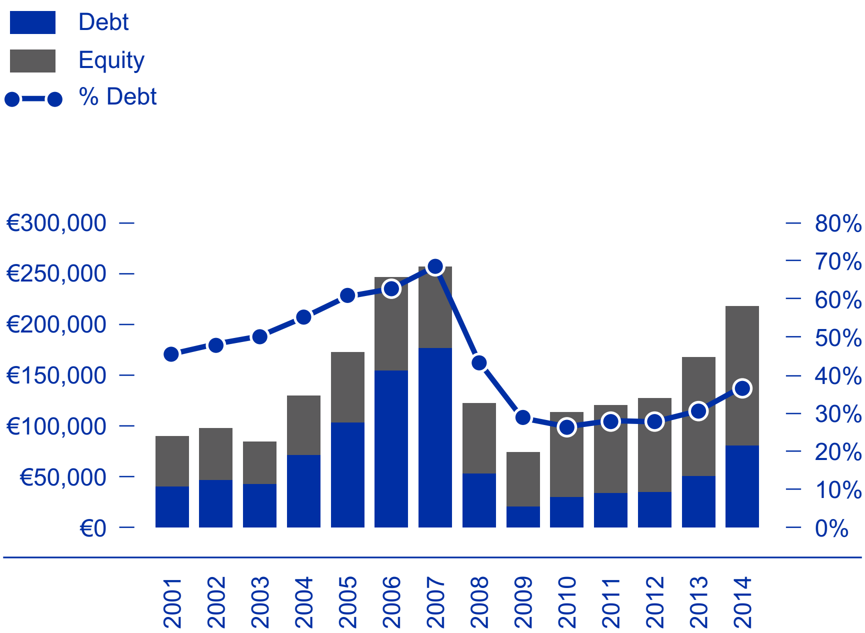
Commercial real estate[1] (CRE) debt is a bedrock of the growth and sustainability of the EU economy and society. As a principal component of CRE capital, it facilitates the contribution that the CRE industry makes to the European economy. Of the estimated EUR 2.1 trillion of invested CRE stock at the end of 2014, an estimated EUR 978 billion is financed by debt representing approximately 47% of the value of CRE holdings.

The increased use of debt by the CRE industry in the run-up to the global financial crisis (GFC) and the consequent fall-out post crisis prompted both an industry and regulatory focus on the future role of debt in the sector (Figure 1).

Debt undoubtedly increases the amplitude of the CRE cycle, posing risk management challenges that neither lenders nor their regulators have so far managed to solve. But the financial stability threat from CRE debt should be seen in the context of the critically enabling role played by debt in the CRE market. Businesses' ability to rent premises flexibly, allowing them to grow and evolve, is underpinned by the ability of professional CRE developers and investors to borrow.

The recovery from the GFC has seen a dramatic reshaping of CRE debt markets in Europe, with banks no longer as dominant, and a variety of sources of non-bank capital drawn to the risk/return characteristics of CRE debt. This newly diverse environment, while welcome, further complicates the challenge facing policymakers, who seek ways to regulate that are fairer and non-distorting, while encouraging the greater resilience that structurally diverse markets can provide.

Figure 1 Breakdown of CRE Investment Volumes by Debt and Equity 2001 to 2014 (mn)



Source: CBRE (2015)

Benefits of CRE Debt

The benefits of CRE debt are widely felt in the European economy, underpinning much of what the CRE industry provides. As an integral part of CRE investment, CRE debt finances the provision of efficient and effective social and business infrastructure in the form of suitable offices, retail outlets, industrial premises, leisure facilities and student accommodation, as well as hotels, educational and health facilities. This provision lies at the heart of a productive and efficient economy and ensures that the built environment suits the changing needs of business and society.

The CRE industry's ability to access debt enables greater flexibility and agility for European businesses. This can be particularly the case for small and medium enterprises (SMEs), which can rent premises rather than buy and therefore use capital more efficiently to expand, improve productivity or for R&D. For SMEs that own their premises, it is typically their ability to provide CRE as collateral that allows them to borrow on reasonable terms.

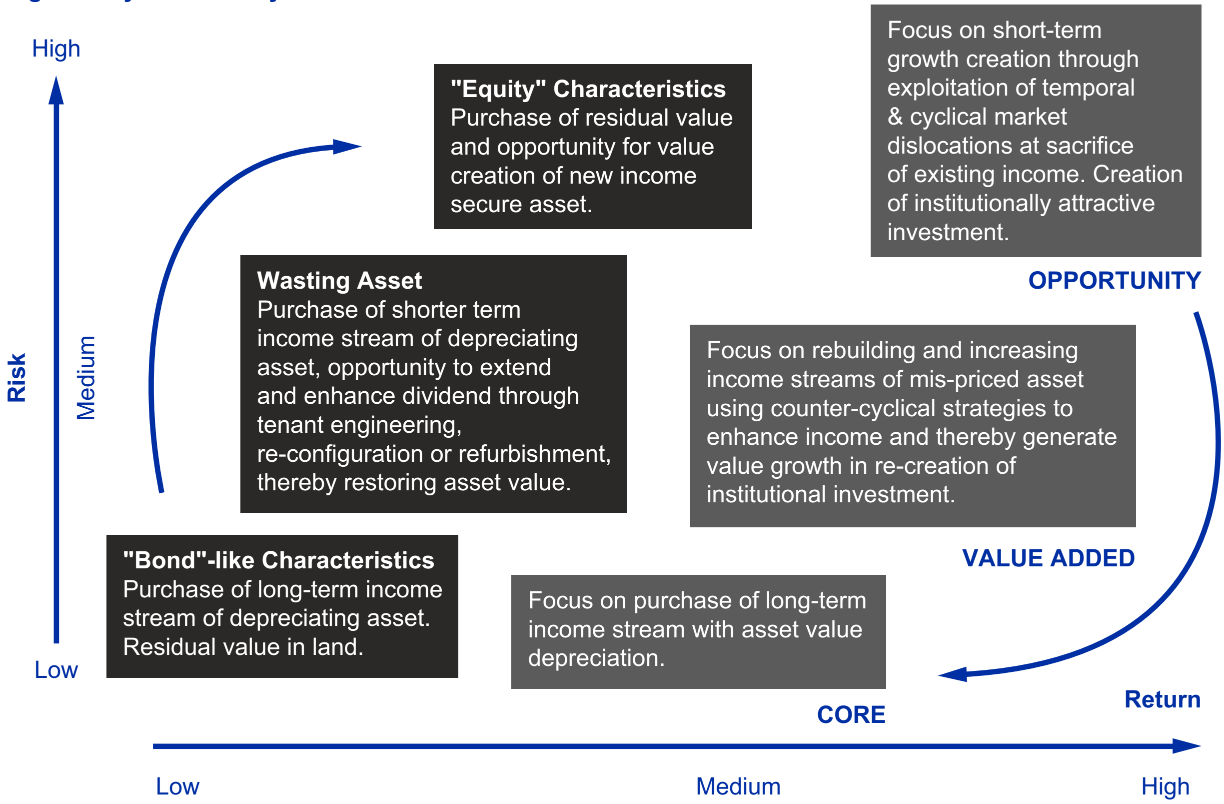
With the CRE industry's important role in providing the infrastructure for business, it also follows that CRE debt is pivotal in the development and renewal of buildings. The capital intensity and timing of cash-flows associated with CRE development mean that most developments would not be viable without short-term finance to support delivery of individual projects. Buildings also lose value unless money is periodically spent maintaining, refurbishing and sometimes redeveloping them, again, an activity that is often made possible, or more cost effective, by CRE debt.

On average, development and re-development of new and existing CRE amounts to EUR 250 billion of capital investment per year, representing 10% of total capital investment in Europe. A further EUR 1.7 trillion is invested in the inter-dependent and related housing and infrastructure sectors. This building renewal also contributes to advances in sustainability, where investment is usually undertaken as part of asset refurbishment or redevelopment plans and is often dependent on the availability and cost of debt.

CRE debt also protects the value of investments. Real estate is unique in that it is one of the only investments that can transform its risk profile over its lifecycle. The same asset can behave like a bond or an equity depending on its ownership and/or risk profile. The quality of a building also changes over time, with new regulations, innovation and changing business practices all impacting building performance and functionality over its lifecycle.

The exploitation of real estate lifecycles represents an opportunity for investors and for wider business and society. This is funded by a combination of debt and equity, and typically some degree of debt financing is pivotal to achieving required returns that enable CRE owners to undertake this important activity for the economy (Figure 2).

Figure 2 Dynamic Lifecycle of Real Estate



Source: Adapted from Genesta, Property Nordic, 2012

As part of this investment activity, CRE debt can serve as a valuable source of secure, stable medium- and long-term income which is beneficial for institutions' asset liability matching requirements. It allows institutional investors such as pension funds and insurance companies to exploit the existence of a structural liquidity premium over the risk free rate, which compensates for the risk associated with lower transparency and illiquidity.

Of course, CRE debt is itself a source of stable, medium- and long-term income with very attractive characteristics for institutional investors. In the pre-GFC world, there were limited opportunities for non-banks to gain exposure to CRE debt (commercial mortgage-backed securities, or CMBS, were the main route). Since the GFC, the contraction of banking activity and the emergence of debt funds, new origination, intermediary and advisory platforms, as well as a flourishing loan syndication market have opened up CRE debt as an asset class to other institutions such as pension funds and insurance companies. CRE debt can accommodate a variety of investment strategies, offering a broad risk/return spectrum. Different investment channels also give rise to a range of possible outcomes in terms of transparency, comparability and secondary market liquidity.

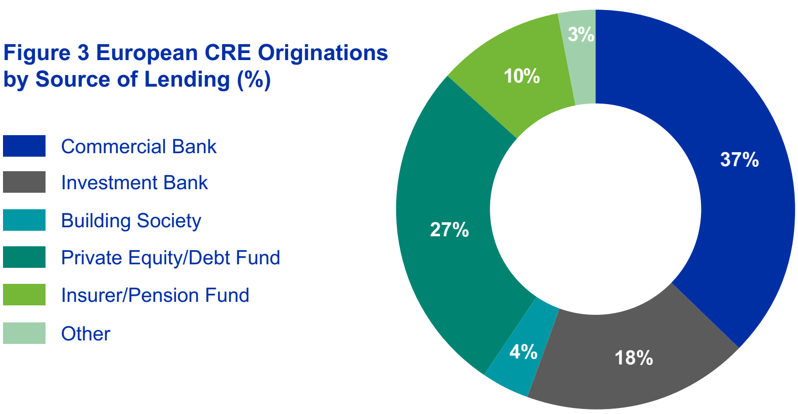
With high levels of activity from the CRE sector, it is no surprise that CRE debt makes a contribution to employment levels. The CRE debt industry is itself a significant employer, as well as indirectly supporting the jobs of the 3.8 million people employed by the CRE sector. Directly, it employs those involved in the management of loan portfolios, origination and distribution, having a high value add. Meanwhile, loan processing and servicing generates the largest volume of jobs and includes jobs associated with the IT infrastructure that supports the CRE debt business.

Indirectly, it supports employment across the sector but CRE debt has an especially important role to play in unlocking construction activity, which provides the majority of direct employment in the CRE sector, and employs a high proportion of lower skilled workers.

Changes in the CRE debt market post crisis

In addition to the wider external benefits of CRE debt, it is also important to reflect on the changes to the structure of the European CRE debt market since the GFC. Pre-crisis, bank balance sheets accounted for approximately 90% to 95% of European real estate lending. Much of the CRE debt that had been securitised also turned out to have remained within the banking sector. The high concentration in a single, critical part of the financial system increased systemic fragility and, following the downturn in CRE markets, created a credit drought that contributed to the GFC and slowed the recovery.

Figure 3 European CRE Originations by Source of Lending (%)



Source: C&W Corporate Finance, AXA IM – Real Assets (data as at 2014)

The scarcity of CRE debt from traditional banking sources in the years immediately following the GFC created an opportunity for a range of new lenders (Figure 3) who stepped in to meet the demand for credit in the CRE industry. Insurance companies in particular have become active directly as lenders, as third party managers of institutional capital, and as passive investors in independently managed debt funds.

A range of specialist debt funds emerged to exploit the opportunity in distressed debt, and have proved instrumental in helping European banks and national asset management agencies dispose of unwanted pre-crisis exposures. This has allowed problem loans to be restructured, unlocking both new investment in existing real estate and the availability of new bank lending for the economy as a whole. The range of banks and non-banks willing to participate in a growing CRE loan syndication market has also expanded significantly, making up, in some ways, for the weak recovery in securitisation markets.

This means that while banks remain a major source of CRE debt, their share of new lending has reduced. Analysis of the UK lending market for 2015 indicates that banks accounted for 75% of new CRE lending, with insurance companies and debt funds comprising 16% and 9% respectively.

This growing participation of institutional capital and longer-term savings in the CRE debt market serves to enhance financial stability more generally, as well as delivering stable long-term income to those who seek it and supporting the overall contribution of CRE to the economy.

Regulation

The final issue to consider is the impact of regulation on the sector. The regulatory response to the GFC has had some positive impacts for CRE debt markets, but also a number of unintended consequences.

One such consequence is the different regulatory silos that have been developed independently as a result of the urgency to put in place separate regulation for individual components of the financial system. This is seen to have limited the extent to which regulators are able to maintain an overview of the interaction of separate regulatory changes.

The relatively sudden diversification of CRE debt provision has also created unresolved challenges for regulators who need to ensure regulation is appropriate for each different type of lender, but also fair so that competition is not distorted unnecessarily. That balancing act, combined with the need to protect the supply of credit to the real estate economy, presents policymakers with a task that is made even more difficult by the variety and complexity of the regulatory frameworks applicable to, in particular, banks and insurers.

In general, all lenders are supportive of the need for better regulation and supervision of the CRE debt industry. However, further policy decisions will hopefully take into account the significant contribution that CRE debt makes to the industry and the wider economy, and that policymakers seek to understand that positive evolution of the industry since the GFC.

[1] There is no universally accepted definition of what, precisely, is included in the definition of commercial real estate. As a starting point, the term encompasses any real estate asset that is owned as an investment for the income it produces, typically in the form of rent. Where the relevant asset is used for commercial purposes by its occupier(s) (obvious examples are office, retail or industrial property), there is no doubt that it falls within the definition. However, large multi-family residential properties share many of the income-generating investment criteria that are sought by investors in office, retail or industrial properties. Many institutional investors and industry observers therefore assimilate such residential rental portfolios to “commercial real estate”, despite the fact that the occupational use of the asset is residential rather than commercial. That is not the case for owner-occupied housing, of course; and even in the case of rental homes, there is no definitive consensus, including as regards how the line should be drawn between small-scale private lettings (which few would regard as commercial real estate) and institutional multi-family portfolios.
For this document, the narrower definition has been preferred, so as to exclude real estate with a residential occupational use. It should however be noted that there is some unavoidable inconsistency (noted wherever possible), because data on commercial real estate do not always draw the boundary on a consistent basis, and sometimes include real estate held for investment property but used for residential purposes alongside more unequivocally “commercial” real estate.

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Full report at: www.inrev.org