Talking point

CMBS: Refinancing risks have not become smaller

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One of the factors cited as having triggered the economic crisis is the housing market bubbles in the United States and Europe. However, one factor frequently overlooked is that many commercial real estate markets had also shown signs of overheating before the crisis: the office and retail property markets had witnessed a largely debt-financed investment boom up to 2007 – similar to the housing markets. The trend is now about to boomerang, for numerous portfolios are currently up for refinancing. It is not going to be an easy job – neither in Europe nor in the US.

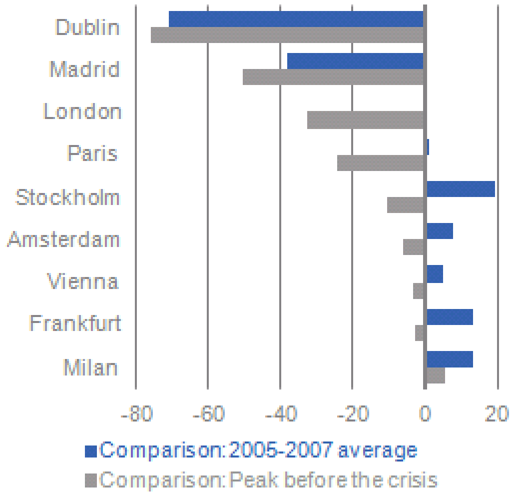
The refinancing exercise applies to both conventional commercial real estate loans as well as securitisations. In volume terms, the bank loan continues to play a more significant role than capital market financing via, say, commercial mortgage-backed securities (CMBS). In Europe, the CMBS market accounts for around 7% of all commercial real estate financing, and in the US roughly 22%. Even though it has a small share the development of the CMBS market is significant because the refinancing of such vehicles might be more difficult than for traditional bank loans. Interestingly enough, this is due to the actual strengths of the product, that is the heterogeneity of the tranches and the small scale of the minimum investment: in a CMBS transaction investment interests vary widely and as a rule there are many participants. Both aspects make it difficult to negotiate a refinancing deal.

The actual magnitude of the challenge is highlighted by the fact that the market is limited by four negative factors:

First, in many markets the capital values for office buildings are still far short of the pre-crisis levels despite a moderate improvement over the past few quarters. The capital value for a good-quality office building in Madrid and Barcelona is down 50% from the pre-crisis peak, in Dublin 76% and Paris 24%. Only a few cities, including Frankfurt, Milan and Vienna have already seen prices return to their former levels. Note, however, that all these data apply to the particularly sought-after "prime locations" – the shortfall on commercial properties in peripheral locations is probably bigger. At refinancing time such a shortfall can lead to an equity deficiency – even assuming that debt ratios similar to those reached before the crisis could still be achieved today.

Capital values have yet to stage a full recovery

Capital values for prime office real estate in Q2 2011 versus pre-crisis levels (%)



Source: CBRE

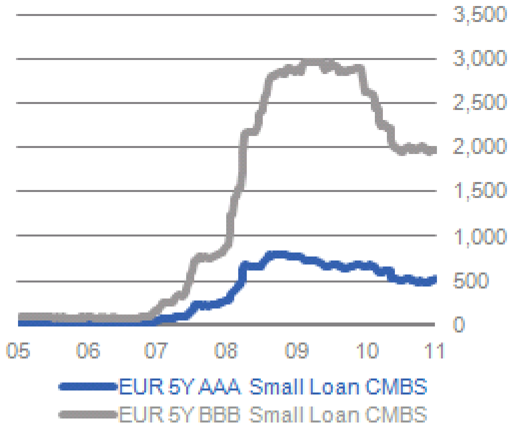
Second, the growth expectations for both the US and European economies have had to be heavily revised to the downside over the past few months. We currently expect the US to post real GDP growth of only 2.5% for 2012, and the euro area close to 1.5%. This leaves hardly any scope for higher office rents. The upshot is that today it is even more unlikely than 12 months ago that the financing problem will be solved simply on the back of higher GDP growth.

Third, new regulatory obstacles are looming: the transposition of Basel III into the European Capital Requirements Directive IV (CRD IV) will also entail changes to the capital underpinning of commercial real estate loans. Institutions are now to be explicitly required to assign "speculative real estate financing" a risk weight of 150%. This could impact exposures to commercial real estate financing that so far have enjoyed a lower risk weight. A higher risk weight will make lending more expensive. Moreover, the new capital requirements will raise the demands on the numerator (core tier 1 capital) in terms of quantity and quality. At the same time, the risk weights for calculating the total risk position (denominator) will in some cases be increased or linked to higher requirements.

It will be difficult to calculate the impact since the EU member states will be given considerable scope to alter key factors such as risk weights or the requirements for preferential risk weights and the countercyclical buffer. The new equity capital rules are to take effect on January 1, 2013.

Fourth, the low degree of transparency in the securitisation markets continues to breed mistrust. Even if this argument is disregarded, the fact remains that the issuance volume in the CMBS market still falls far short of the pre-crisis level. Over the past three years, the volume of new CMBS issuance in the US market did not average more than USD 15 bn per year, one-eighth of the average volume possible during the pre-crisis years. In Europe, the discrepancy is somewhat smaller. But here, too, issuance totals only about 1/3 of the annual average before the crisis. However, on both sides of the Atlantic there have been only few CMBS issues placed with investors. The bulk of the remainder serves as collateral for repo transactions with the central banks. The shortage of market liquidity is reflected in CMBS prices accordingly: even in the category with little default risk, the spreads on European CMBS issues – that is, the measure of the risk linked with the bonds – are 20 times higher than the pre-crisis level. Even assuming that the current spreads do not reflect the actual fundamentals, they do show that the market is still not operating “normally”.

Spreads are still high



Source: Markit

So, looking ahead, sizeable refinancing risks loom particularly for those products connected with real estate in markets with sharp price corrections from 2005 to 2007 (ES, IE, US) and/or a poor economic outlook (PT, ES). Similarly, it holds for all products that every instrument which is able to attract fresh equity or debt capital to the commercial real estate markets has to be welcomed. This applies to Pfandbriefe just as much as it does to mutual funds, direct investment or REITs. Logically, the share of commercial real estate loans in the cover pools of German Pfandbriefe (mortgage bonds) increased from 40% in 2007 to 52% in Q2 2011. Thus it is entirely possible there might be (limited) opportunities linked with the challenges. This holds not only for real estate financiers, but especially for well-capitalised real estate investors – with by no means only a long-term focus.

Please see also:
Commercial real estate loans facing refinancing risks: CMBS only part of a growing problem

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