Research Programme 2006-2009

The Association of Property Bankers

Property Banking Forum: Lending Intentions Survey 2011

IPF Research Programme Short Paper Series Paper 13

March 2011

This research was commissioned by the IPF Research Programme 2006–2009

IPF Investment Property Forum

This research was funded and commissioned through the IPF Research Programme 2006–2009.

This programme supports the IPF's wider goals of enhancing the knowledge, understanding and efficiency of property as an investment class. The initiative provides the UK property investment market with the ability to deliver substantial, objective and high quality analysis on a structured basis. It will enable 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 24 businesses, representing key market participants. The IPF gratefully acknowledges the continuing support of the contributing organisations.

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IPF Research Programme Short Papers Series

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In December 2010, the Association of Property Bankers (APB) and the Investment Property Forum (IPF) formed a group, known as the 'Property Banking Forum' (PBF), the purpose of which is to carry out and disseminate research and to inform those involved in property finance and investment about the issues affecting property finance. The PBF comprises representatives from a number of leading banks and investors active in the market. As its first action, the PBF commissioned Alex Catalano to carry out this short research project, with the aim of gaining a better understanding of potential lender activity and intentions for the year ahead.

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Author

Alex Catalano, *Real Estate Capital*

Project Steering Group

Peter Clarke, *Recept Consulting Limited*
Timon Drakesmith, *Great Portland Estates plc*
Sue Forster, *IPF*
Andrew Goodbody, *DG HYP AG*
Richard Payne, *Barclays Corporate*
Max Sinclair, *Eurohypo AG*

Summary

- There will be £18–£21bn of senior debt available for UK commercial real estate in 2011, 30–50% more than the lenders surveyed provided last year;
- 70% of the banks surveyed said they would be providing more senior real estate debt this year.

  This additional lending comes despite the fact that Basel III and increased funding costs are constraining banks.
- Insurers are increasing their lending very significantly this year;
- The actual volume of lending will depend on whether the opportunities are available;
- Basel III and increased funding costs are reshaping banks' lending, increasing their focus on lower loan-to-values and relationship borrowers;
- Substantially more senior debt is available for 'quality' value-added and secondary real estate this year. In 2011, 70% of those surveyed will lend on these assets against 40% last year;
- Five lenders will consider financing prelet developments;
- Margins (on prime assets, 60% LTV) are 200-250bps and expected to remain at this level in 2011;
- Arrangement fees are 75-100bps and also not expected to change this year;
- Only two respondents are prepared to lend unsecured, but others may do so exceptionally for relationship borrowers;
- Loan size is capped at £50m for most respondents, with a handful prepared to underwrite larger amounts;
- There is a chance CMBS may restart in 2011, albeit in a simpler and more transparent form.

Survey details

A total of 27 lenders were canvassed: 24 banks and three insurers. Of these, 23 participated in the exercise. Three of these were interviewed but did not provide data for the questionnaire. Accordingly, the survey results do not include their lending. In one further case, the respondent provided partial data, so the lending intentions figures included are an estimate.

Main findings

Senior debt in 2011

Over the last three years, the number of banks lending to UK commercial real estate has contracted sharply. However, a hard core of both UK and international lenders remain committed to the market and they will be providing more finance for it this year. According to the Property Banking Forum's survey, there is approximately £18.2–£20.8bn of senior debt available in 2011. This is 30–50% more than last year, when the lenders surveyed originated £14bn of loans.

This capital will be provided by a small group of around 20 lenders that remain active in the UK. It is unlikely that entirely new players will enter the market in any significant scale this year, but nearly 80% of respondents are planning to increase their lending, in some cases very substantially.

Over the last two years, banks have tackled the problems in their loanbooks and are now prepared to move on. Insurance companies, who have been minor players in the market to date, are scaling up their lending. However, there are two caveats. First, the real estate lending market is being reshaped by impending regulatory changes. On the banking side, capital is constrained. On the insurance side, there is considerable uncertainty over how Solvency II, the new European regime, will apply to real estate debt.

Second, the opportunities available in 2011 will determine whether these intentions translate into practice. The majority of respondents said they would have lent more in 2010, but could not find the right deals. On prime investments, their clients were being outbid by equity players, many of whom were cash buyers: sovereign wealth funds, insurance companies and pension funds.

In 2011, lenders are expecting increased demand for their debt. They think that there will be a bigger flow of commercial real estate to finance coming from UK and Irish banks and NAMA. Even so, most of those surveyed think it will be difficult to meet their lending targets. "The question is whether there are enough deals coming through where we see opportunities, and are they with borrowers that we want relationships with?" said one banker.

This highlights another feature of the market in 2011. Because they are husbanding their capital, banks are defining their commercial real estate lending tightly. They are quite specific about the size of loan, asset type and quality, and borrowers they wish to back.

Regulatory constraints: Basel III and Solvency II

The international rules governing the amount of capital that banks and insurance companies must hold to weather financial shocks are changing. This regime change is re-defining both the total amount of debt they will devote to real estate and the kind of real estate loans they are prepared to underwrite.

Basel III, which will apply to banks worldwide, is making it much more expensive for them to lend longer term and on riskier real estate. The new regulations are being introduced in 2012 and will eventually more than treble the amount of 'core' capital that banks must hold to protect themselves from losses: effectively increasing it from 2% to 7%. Banks will also be required to hold a minimum amount of highly liquid assets to ensure they could survive if financial markets seize up for 30 days.

Although Basel III rules do not come into play fully until 2019, banks are preparing themselves. They are husbanding capital to meet the targets, counting the new capital costs of loans and rearranging their business accordingly. "Our return targets have shifted a lot in the last year because of regulatory requirements", said one respondent.

Under Basel III, conservative, 'plain-vanilla' loans on prime investment property are not onerous in capital terms, but as soon as lending moves away from this safe haven into riskier territory — for example, higher loan-to-value, secondary properties, or development — the capital cost rises rapidly. "Basel III will damp down our return on equity; it does focus our minds", said a banker.

European insurance companies also face a radical regime change. Like the banks, they will have to hold more capital to cover themselves against a downturn in riskier, more volatile assets. Solvency II, which establishes these new, stronger capital requirements across the European Union, is due to go live on 1 January 2013.

There is still some uncertainty about these rules and how they will be applied, but it is clear that Solvency II has serious implications for the way insurers invest in real estate. It appears to favour conservatively-structured real estate debt over direct real estate or real estate equities.

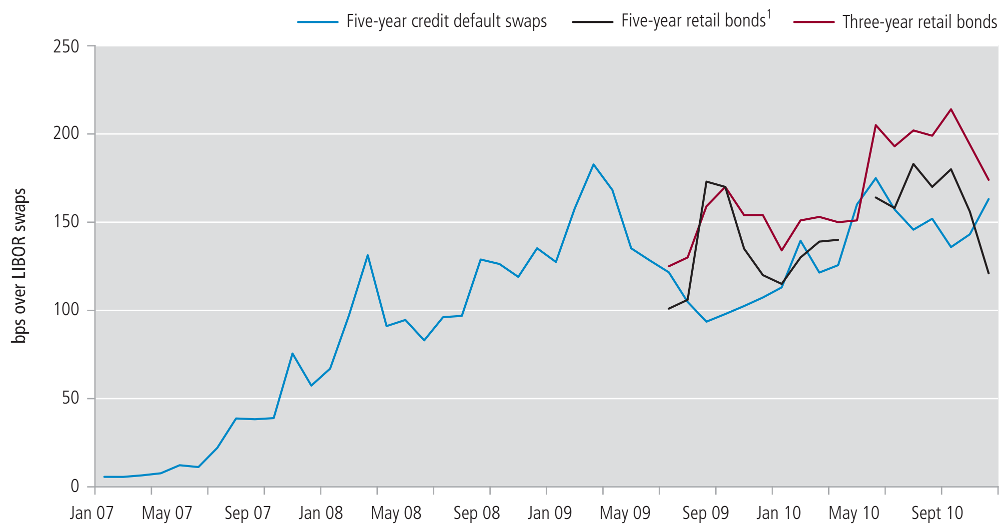
The sheer volume of regulation facing lenders is worrying them. There is a long list of changes: the 2010 Dodd-Frank Act in the United States, Solvency II, and Basel III. "The biggest risk to business right now is the implementation of this confluence of regulation from around the globe — whether you have conflicting or contradictory regulations or legislation coming out in different countries and the implications", said one banker.

One particular concern involves the differing disclosure, monitoring and reporting now required by different regulatory regimes on real estate loans. For example, borrowers will have to disclose more, and report much more frequently, on loans that are securitised, as compared to what a bank might require from them, assuming they are trusted clients with a good track record. "If regulators don't eliminate the information arbitrage between the balance sheet lender and the capital markets lender, why would anyone sign up for a loan to go into a capital markets transaction?" noted one respondent.

Funding sources and costs

Funding costs were frequently mentioned by bankers as a constraint on lending. Banks fund their lending from a variety of sources, depending on their mix of business: retail accounts and savings products, borrowing on the wholesale markets or from their central bank. Although base rates have remained low since the 2008 financial crisis, the cost of wholesale and retail funding has been volatile. It spiked again last year when the sovereign debt/Euro crisis re-ignited investors' fears about the fragility of the banking sector. Over the last quarter of 2010 banks found their access to wholesale funding had deteriorated and costs had increased sharply (see Chart 1 on the following page).

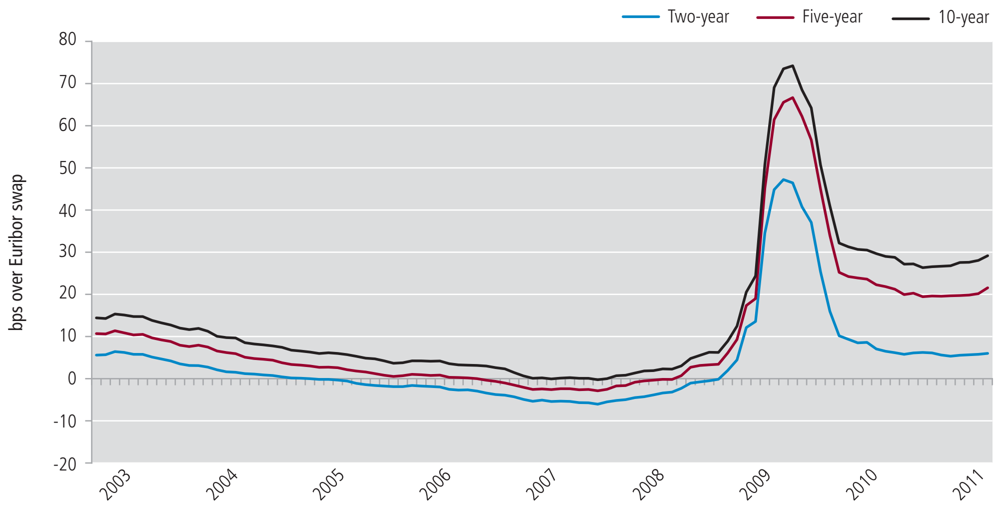
Chart 1: Five-year funding costs



Source: Bank of England, Bloomberg
The unweighted average of the premia on five-year credit default swaps of six major UK banks is used as a proxy for the spread on long term wholesale bonds

German banks, which have been prominent in lending on commercial property in the UK, have a special weapon in their funding armoury: mortgage Pfandbrief. These are government-regulated covered bonds, backed by pools of commercial (and residential) real estate loans, which banks can issue to raise funds. They provide a liquid and relatively cheap form of finance: the spread on a five-year mortgage Pfandbrief is 22bps over the Euribor swap rate. As the chart below shows, apart from a brief spike during the financial crisis of 2008–2009, Pfandbrief spreads have remained relatively stable, albeit higher than pre-crisis.

Chart 2: Mortgage Pfandbrief funding costs



Source: Association of German Pfandbrief Banks

[1] The series for the five-year bonds is not published for May 2010 as only two or fewer institutions in the sample offered products during that period.

However, Pfandbriefe have their limitations. In theory, loans of up to 60% of a property's value can be included in the collateral pool. But German regulations specify both the kind of properties that are eligible and, crucially, the method of valuation: 'mortgage lending value'. This is a 'sustainable value' that does not take into account the temporary 'economically induced' fluctuations of the relevant property market values and excludes 'speculative' elements. It is quite different from the RICS Red Book definition of open market value, which is normally used in the UK as the basis for lending.

Therefore, although up to 60% of a property's market value can, in theory, be eligible for Pfandbrief, in practice it may be substantially less, sometimes only about 40%. Any lending over the 'Pfandbrief-able' amount has to be covered by other — typically more expensive — sources of funding. German Pfandbrief banks that do not have a retail deposit base typically raise about half their funds from the wholesale markets. Furthermore, it should be noted that Pfandbriefe remain on the banks' balance sheet, so they still count for Basel III purposes.

Refinancing vs new lending

The survey found that, in 2011, up to two-thirds of all the senior debt available would be used to finance entirely new transactions rather than refinancing existing loans (either from the lender's own loanbook or other people's) on current market terms. This is about the same proportion as last year. This relatively high amount of intended 'new' activity may reflect respondents' expectations of a more active investment market in 2011. In addition, there are a number of lenders with quite small existing loanbooks who intend to grow them substantially this year by funding new deals.

Secured vs unsecured lending

Unsecured lending to commercial real estate borrowers is deeply unpopular. Only two respondents are lending on an unsecured basis in 2011. Indeed, for most of the German banks, secured lending is a keystone because, otherwise, the loans cannot be used for Pfandbrief funding. But even banks that have the capacity are shying away from unsecured corporate loans to real estate businesses — the capital costs are too high and the margins too low. However, they may make exceptions for strong relationship borrowers who can provide profitable business for other parts of the bank.

Loan size

With capital constrained, the size of senior loans is being squeezed at both ends. Since both the syndication and CMBS markets are effectively shut, banks find it difficult to underwrite large loans. Few can afford to keep loans of over £100m on their balance sheet.

For most lenders surveyed, the maximum they will provide for one transaction is £50m; a few will stretch to £100m, and one or two are prepared to underwrite much larger deals. Thus, loans over £100m require clubs. Since the financial crisis, both lenders and borrowers are reluctant to join large clubs, preferring bilateral loans or teaming up with two or three like-minded lenders who can be relied upon if problems arise. "Clients are looking for banks who will be there, so they can manage their business properly", noted one respondent.

Debt is also being rationed at the smaller end of the loan scale. For some lenders with larger, more granular loanbooks, the financial crisis has spotlighted the long tail of small real estate loans — under £10m — on their books.

This small-scale lending adds up to a substantial sum. The operational costs are high and the losses, though small, can be more frequent. "Where we lose most money is at the bottom end of the book. There's a general drive towards a focus on larger loans and better quality clients that are more actively managed", commented one banker.

Borrowers

Relationship banking is back with a vengeance. Respondents are unanimous in targeting a tightly-defined group of clients. "We are no longer purely liquidity providers" is a frequent refrain. This sharpened focus is driven by the need to earn better returns on equity and boost profitability. Although the financial return on real estate debt compares well to what banks can earn on other types of loans, the 'relationship return' is quite thin, as it is often limited to the debt and associated hedging.

"The challenge is, do we want high-return debt but nothing else, or more stable income?" noted a lender. "We're looking in part for clients who will do repeat business rather than one stellar deal and then you don't see them for a couple of years." The ideal borrowers are "good property people who have relevant real estate platforms. That makes it more difficult because it narrows the range of opportunities."

Property preferences

Last year, 70% of respondents said they concentrated on what they called prime property, though in practice, prime is a pliable term. This year, most recognise that their opportunities to finance trophy assets will be few and far between. Now, 70% are prepared to devote 20% or more of their 2011 lending to value-added and good secondary real estate, where skilled asset management can enhance value.

And, unlike last year, financing development is not entirely ruled out. Five respondents are prepared to do so — in one case, to the extent of a quarter of their 2011 lending. However, preletting is a prerequisite and central London offices the favoured ground.

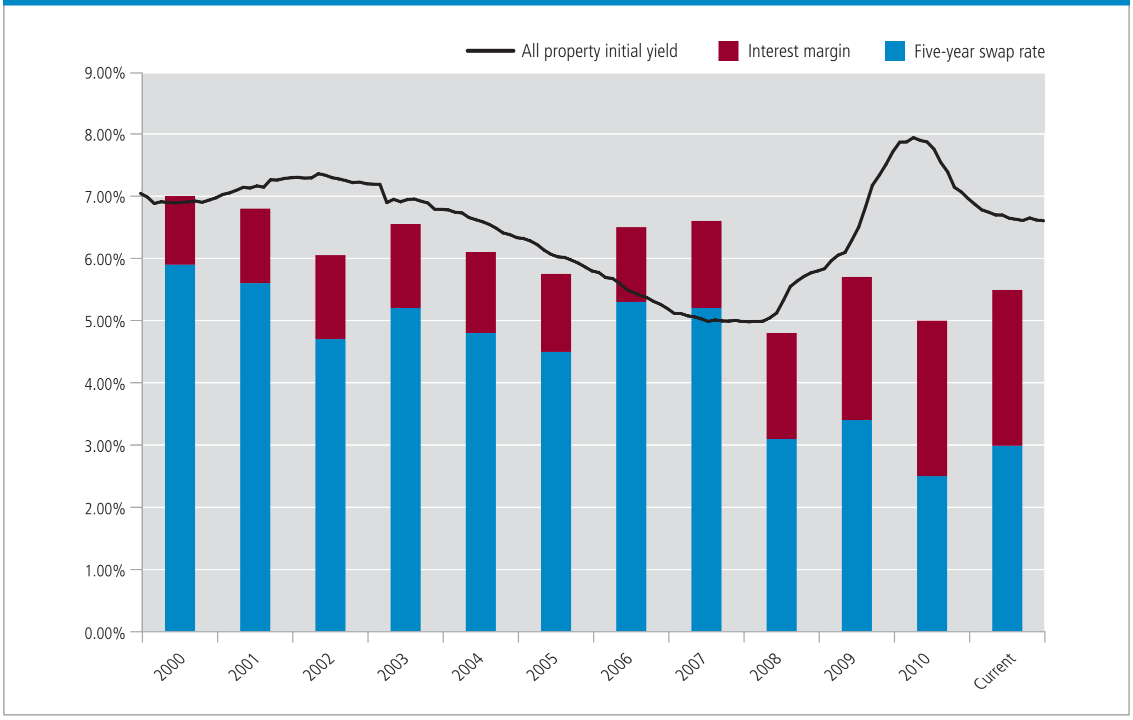
Sectorally, most senior debt is firmly aimed at the mainstream: offices, retail, logistics/industrial, and to a more limited extent, hotels and residential. Hardly any of the lenders surveyed are prepared to move into niche sectors like leisure, student housing or nursing homes.

Geographically, lenders are focussed on London and the South-East. Outside this area they are very selective and monitoring the local economies. They are worried about how the UK's austerity programme will affect consumer spending and occupational demand. "We're keeping a close eye on towns and cities that are reliant on the public sector", said one.

Lending margins

The margins for a straightforward five-year investment loan, assuming that the asset, borrower and income stream are all top quality and a 60% loan-to-value, currently range from 200bps to 250bps. See Chart 3 on the opposite page. "There is a constraint on the capital available in the system. We'd be hard pressed to go below 225–250bps", said one banker. All things being equal, most respondents expect margins to remain at this level in 2011. "Margins won't get tighter; borrowers have to be realistic", it was suggested.

Chart 3: **Cost of five-year sterling bank debt vs yields**



Source: Investment Property Databank, Eurohypo, JC Rathbone Associates

That said, pricing loans involves balancing a complicated set of criteria: the credit risk associated with the transaction, a rating (which takes into account the quality of the property, the leases and the borrower), the regulatory capital that the loan consumes, the lender's own cost of funds and the lender's required return on equity.

Thus, debt for 'good' secondary will carry at least 50bps more; larger loans will also tend to be more expensive. "For deals over £150m the air is thinner," noted a banker.

In rare cases, lenders may charge less — perhaps as low as 175bps. However, this is recognised as a loss leader — a special rate that is extended to a very few relationship borrowers because their current or future business provides income to other parts of the bank.

Insurance companies tend to price their loans differently, charging fixed rates at a margin over gilts. The margin is currently 175–225 bps and likely to stay in that range this year. However, on shorter (five- to seven- year) loans some insurers mimic the banks' offer of LIBOR-based loans.

Fees

Arrangement fees are 100bps, with a few lenders charging 75bps. On more complicated transactions, such as developments or deals that require speed, they are higher. They are expected to stay at this level in 2011.

Pre-payment fees were mentioned by several respondents. Pre-payment is a particularly serious problem for insurers who are lending at fixed rates to match longer term liabilities. They charge a flat-rate break fee, to discourage borrowers from refinancing too quickly, plus the breakage cost, which is essentially the net present value of the difference between what the borrower would have paid for the remaining term of the loan and what the outstanding balance of the loan would earn if reinvested at current rates.

Sources of senior debt in 2011

Banks

The UK's commercial property market remains one of the top-ranked for international banks. It scores highly on liquidity, transparency, lending opportunities and profitability. But global banks look for relative value across the world. "We're maintaining our commitment, but it is difficult to justify increasing the capital allocation to the UK", noted one.

Among international lenders, German banks are particularly prominent in the UK. According to recent Bundesbank estimates, Germany's 11 leading banks hold £29bn of UK commercial real estate loans. For them, the returns they earn in the UK are higher, and the competition less intense, than in their domestic market.

However, Germany's banking industry is in flux. Some of the state-owned regional Landesbanks are struggling to meet Basel III capital requirements (see p6). This pressure is blamed for the recent decision of one German bank to close down all its international real estate lending, despite the UK arm being profitable. In other cases, German banks that have received state aid are under European Union orders to sell off parts of their businesses, which will include two major lenders in the UK.

Of other European banks, there is a small contingent of French banks that finance commercial property in the UK. They weathered the financial crisis relatively well and also appear to be gearing up to lend more this year.

There is also speculation that Chinese and other Asian banks, which are well capitalised and do not have to de-leverage, will eventually expand into the UK market. The state-owned Bank of China is growing its residential mortgage business and financed a high-profile hotel deal; China's largest bank, the Industrial and Commercial Bank of China, is also setting up a retail lending business in the UK. However, neither has yet established a commercial real estate platform here.

Insurance companies

In the US, insurers account for 17% of commercial real estate mortgages, but in the UK they are a very small part of the market. However, the few that do provide senior debt are all are expecting to increase their lending very significantly this year. "We could do £1bn without flinching", said one. Other continental European and US insurers are also preparing to invest in senior European real estate debt.

The reason for this surge is threefold: returns, regulation and opportunities. Insurers have plenty of money to invest and are under pressure to improve their returns. Traditionally, their fixed income portfolios have been heavily biased towards gilts, but the low yields on these are driving them into other asset classes, including senior real estate debt.

It provides good risk-adjusted returns relative to other fixed income investments, such as comparably rated corporate bonds. And longer-term lending matches insurers' longer-term liabilities, like annuities. Moreover, Solvency II, the new regulatory regime which will apply to European insurance companies in 2013, seems likely to treat real estate loans relatively benignly from a capital standpoint. And, for international players, UK lending helps diversify their portfolios.

Insurers are also anticipating growing demand for their lending, given the amount of debt that is needed to refinance bank loans and CMBS. With the limited competition and liquidity that banks can provide, insurers see a golden opportunity to scale up their lending, especially on the bigger-ticket assets and portfolios that banks find difficult to finance. Borrowers' attitudes have also changed. They now see benefits in diversifying the maturities of their debt and forging relationships with lenders who are long-term players. "In some cases people feel it's important to have a non-bank in there too", noted one insurer.

But again, how much debt insurers will provide in 2011 depends on a flow of suitable assets. And, for those who use commercial real estate debt to back their annuities, it will depend on how much annuity business they transact.

However, insurance companies' money is not a straight substitute for bank debt. Their time horizon tends to be longer; for example, in the case of annuities, they are looking to match liabilities which may stretch for 20 or 30 years; in other cases, their business model accommodates five- to seven-year loans.

And, originating loans can be problematic, even for well-established players. In the past, it has been difficult for them to break into the relationship between borrowers and their banks. That is changing. In some cases, insurers are establishing relationships with banks and partnering them in loans; in other cases, banks are selling parts of their senior loans, for example, the 0–30% tranche, to insurers. These link-ups are ad hoc and not exclusive, but could evolve into more formal arrangements.

CMBS

Respondents said an active CMBS market is needed to help refinance the mountain of existing loans that are due to mature. Some think it will be "a long, hard road back", but others believe the market will possibly (and tentatively) restart in 2011. But, to make them palatable to investors, the securities will be in a much-simplified form: a simple structure, backed by a prime, single identifiable asset, with appropriate reporting and servicing arrangements.

The few CMBS that have been issued in Europe since 2008 have been more akin to a corporate securitisation, linked to the credit quality of the borrower, rather than the value of the underlying properties. However, there is currently (March 2011) a true UK CMBS deal being circulated among investors. If it finds favour, it augurs well for the market reviving sooner rather than later.

New initiatives

There are plenty of investors, like insurers, pension funds and sovereign wealth funds, that have money to put into real estate debt; banks have the relationships and teams to originate and service loans. Respondents cited several possible ways of tapping this new capital including:

- Banks sourcing new deals for insurers or other investors, while keeping a small portion of the loan, and earning fees for arranging and hedging the debt;
- Banks linking up with insurers to offer existing borrowers refinancing that includes an insurance product;
- Wrapping insurance around a rated bond backed by a portfolio of loans, giving investors additional first-loss protection;
- In the longer term, developing a common platform that the banking industry can use to distribute real estate debt; insurers and other debt investors would know they were getting a trustworthy, standardised product, as with Pfandbrief.

Conclusion

Although the number of lenders has shrunk dramatically since the financial crisis, those surveyed remain committed to the UK market. They are, by and large, comfortable with their loanbooks and prepared to take on more business. But they recognise that, alone, they will not be able to provide the liquidity required for the large volume of loans that will need refinancing in the coming years. Respondents stressed that new sources of capital are essential, and these may lead to new arrangements between banks and new debt providers. And the securitisation market, which has been effectively closed to commercial real estate since 2008, needs to re-open, albeit in a simpler form.

Printed on recycled paper

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