IPF Research Programme 2006-2009

UK Real Estate Debt: A Problem for the Borrowers *and* the Banks

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Mike Phillips, *Finance Editor, Estate Gazette*

Highlights

- Banks are putting in place the organisational and procedural structures to cleanse their loan books
- There will not be a flood of property on the market. However, banks will need to act as wider pressures force defaults and sales. They will try to avoid bringing in receivers, but will not be afraid to oust failing management teams
- The most important issue for banks is to avoid crystallising losses on loans. For banks, this will result in them following a 5 to 10 year workout process. Given they will, therefore, control how much property comes to market and this will be modest, the UK investment market could remain fairly stagnant for some time.
- Default is only being called on loans with income issues. This is a small proportion, of current loans but is set to get bigger as recession puts rents under pressure
- Refinancing is generally occurring, at a price. However, CMBS loans are a more intractable problem for the UK property market.
- Government intervention in UK and Ireland is aimed at reducing the need for banks to pull the plug on borrowers, and so avoid crystallising losses from property

The number is large, and getting larger: £225bn of debt secured against UK commercial property at the end of 2008, compared to £208bn six months earlier.[1] So, what actions are banks now taking to protect their position?

While it is true that banks are not about to flood the market with forced sales, there is some complacency in the commercial property market that this situation must continue. In fact, wider economic and regulatory pressures on banks will force lenders to take action with their property loan books either through calling default on loans, bringing in receivers or administrators and selling assets on, or restructuring debt and bringing in new management teams where previous borrowers are seen to have failed.

For the banks, the critical issue is avoiding the crystallisation of losses where properties are now worth less than the debt lent against them. For this reason, we should not see a slew of forced sales sending asset prices spiralling further. However, the way banks fund themselves and the way their accounts are written means they can not sit and do nothing, as this would also lead to steep losses over the next few years. The pressure on banks to act will also increase as property income begins to decline with falling market rents and rising vacancy rates.

Lenders are at the beginning of a 5-10 year process of putting their property loan books back in order. Government action should help ease this problem, but could also lead to stagnation in the investment market, a point made by Stephen Hester, chief executive of RBS, at the recent BPF conference.

What are banks currently doing with loans in covenant breach?

Discussions between both lenders and borrowers indicate there is a clear distinction being drawn between those loans that are in breach because interest or principal is not being repaid, and those loans where loan-to-value (LTV) breaches have occurred. If the breach is on the income side, the bank has no option but to act. Under international accounting rules [see Box 1 on Basle II, p. 11], material loan loss provisions must be made against a loan if a scheduled repayment is not made within 90 days of the agreed date, with the result that a large amount of capital must be set aside to mitigate against future losses. So, in these circumstances, it is better for banks to act, even if this involves them having to ultimately sell the property at a loss.

At the moment, this form of breach is affecting development loans in particular. Here, there is no income being produced because expected lettings have not materialised or there is insufficient income within a business to complete schemes. For this reason, the majority of high profile property administrations to date have affected developers such as Castlemore, Guestinvest, City Lofts and Mountgrange Capital. In the largest investment-based administration so far (Dunedin's Industrious portfolio) falling income linked to high void rates in the fund resulted in there being insufficient cash flow to manage the business.

Conversely, in the case of LTV breaches, banks currently seem broadly content to work with existing borrowers to amend the terms of the debt through providing an increased loan to value for instance. However, this comes at a price. Banks are typically asking for some of the loan to be repaid; they are also sharply raising interest rates and fees.

The De Montfort survey indicates that the average interest rate margin on a loan secured by a prime office property has increased from 126 basis points over LIBOR (the rate at which banks lend to each other) in 2007, to 213 basis points in 2008. Anecdotal evidence suggests that margins for new or restructured loans are on average in the region of 300-350 basis points. As well as the increased margin, arrangement fees of up to 5% of the loan's value are often being tacked on and exit fees of 200-400bps, or agreements that banks will take a chunk of profits.

[1] Maxted B, Porter. T. 2009. *The UK Commercial Property Lending Market: Year End 2009 research findings:* De Montfort University

There is a sense amongst some borrowers that banks are 'holding them over a barrel' to make a quick profit. Indeed, there is a widespread belief that, perversely, it can be the stronger companies with equity to repay some of the loans, and good properties with good cash flow, that are being targeted first by the banks in terms of having loans restructured with higher fees.

However, the banks argue that they need the increase in fees because the cost of their own funding has increased dramatically. While LIBOR rates have dropped recently, the gap between LIBOR and the base rate is still historically high and other methods of raising capital, such as issuing covered bonds[2], are also currently more expensive than usual. One banker interviewed noted that: "The increase in fees does not even cover our higher cost of funding."

Lenders also point out that if banks restructure a loan and extend it or allow a higher LTV, more regulatory capital must be put aside under Basle II regulations which state that riskier loans with higher LTVs require more additional capital to be set aside. Given this, banks also argue that the current increased level of fees is necessary to help rebuild the capital base of banks and insure against potential losses.

What might force banks to become more aggressive with borrowers?

The recent De Montfort survey indicates that loans in default spiked in 2008. More than 3,000 loans, with a value of over £3.1bn were in default at the end of 2008, compared to 400 with a value of £758m at the end of 2007. As a result, loan loss provisions, which banks have to account for in their profit and loss accounts, increased from £78m to £1.2bn.

In recent interim management statements, major property lenders Lloyds Banking Group and Allied Irish Bank both indicated that they expect to see increases in loan loss provisions.[3] According to estimates made by JP Morgan's banking analyst team in November[4], European banks with a combined total of €1trillion of balance sheet exposure to commercial real estate loans, will make a combined loss of €22.5bn on property loans in 2009, and Lloyds and AIB have indicated that things have got a lot worse since then. This is not something banks can afford to sit back and let happen, as further recapitalisations by Governments will be difficult.

The perception held by some in the property industry that banks can simply choose not to undertake loan to value tests and, thereby, not trigger a problem is also incorrect. Under Basle II regulations, banks are required to undertake regular valuation of the assets that secure their loans. This is usually at least once a year, so banks cannot avoid the problem indefinitely.

The biggest issue for banks deciding what to do with loans will again be income. IPD figures[5] already show rental income in decline. This is due to get worse as more tenants default, more occupiers demand lower rents or increased incentives to take new space, and pre pack administrations lead to lower rents. The most marked effect thus far has been in secondary shopping centres, where retailers are struggling as consumers rein in spending. There have now been several examples of LPA receivers being appointed to sell shopping centres by banks; GVA Grimley alone was appointed as LPA receiver to sell five centres in a single week recently.

[2] Covered bonds are debt securities that remain on the issuer's balance sheet.

[3] In its interim management statement on 7May, Lloyds Banking Group reported that, due to the worsening economic environment, it expected impairments from its corporate loan book for 2009 to be at least 50% higher than the £6.7bn recorded in 2008, around 60% of which came from commercial property. In its interim management statement on 11 May, Allied Irish Bank reported that asset quality in its loan book continued to weaken more rapidly than expected.

[4] JP Morgan, *European Banks: Quantifying Earnings at Risk from Commercial Real Estate,* Francesca Tondi, 4 November 2008.

[5] IPD monthly index figures for April show the pace of rental decline increasing. Rolling three-month rental decline to the end of April was 3.2%, the greatest fall since December 1992.

As rental income comes under pressure, we will see more investment projects join the development schemes and businesses that are failing and banks will be forced to call these defaults to avoid making the provisions they otherwise need to make against non-performing loans.

Loan loss provisions are subjective to a degree, especially where breaches relate to loan to value rather than income. They are based on the likelihood of the bank getting its money back at the end of the loan. To this degree, the bank has some leeway; even if a loan is in negative equity, there is a chance this position will improve before it is due to be repaid. Similarly, in cases like this, even if a bank does make a provision, it might not be a permanent impairment and, if things do turn out better than expected, then in future accounts the provision can be reversed. For this reason, banks will avoid calling an administrator in too soon, as this would mean taking a permanent impairment.

However, the nearer a loan in negative equity is to maturity the less likely it is that values can recover sufficiently to take it back into positive territory.

The latest IPD figures show that property capital values have now moved back to around 2001 levels. With the majority of property investment loans being written on five year terms, this means that a substantial proportion of real estate debt lent since 2003 could be in a negative equity position when it comes to be refinanced. Savills head of UK valuation William Newsom recently estimated that UK property is facing between £38bn and £50bn of negative equity. This will severely limit how lenient banks can be.

Furthermore, if loans go into default, banks now have to hold significant amounts of capital against them on their balance sheet [see Box 1 p.11]. Indeed, new proposals from the UK Government could force banks to hold even more capital against risky assets. In this environment, it might make more sense for banks to act pragmatically and take a loss on a loan than be forced to set capital aside unproductively in this way.

What processes are banks undertaking if they do need to take action?

Most respondents cited the quality of the management team as the key issue in situations where banks do have to take action. "Jangle mail" is the industry argot to signify a borrower handing control of a property back to a bank. In the same way that banks do not want to call administrators in and crystallise potential losses on a deal, they are also not keen to take properties on to their balance sheets and be forced to set large amounts of regulatory capital aside.

As such, they would rather work with existing management where possible, providing they think that management capable. In many situations this is not the case. Those borrowers with little property expertise or management skills and who simply used property as a tool for financial engineering, are cited as most likely to see banks step in.

Perversely, it is also true that some good management teams will end up losing properties. As stated earlier, banks want borrowers to bring more equity to deals, and to increase their fees. This leaves less income for borrowers. Even if borrowers have more equity to inject into a deal, many are saying that the new terms being offered make it unviable for them to continue to manage the property since they are essentially doing so for free.

So, even if administrators are not brought in en masse, there is likely to be a significant change in the ownership of property.

Many banks are looking to bring in new experienced asset managers, especially if they can also bring some equity to deals, possibly working in a joint venture structure. They see this as the best way to avoid crystallising losses or even having to make provisions. Such deals are hard to pull off without banks having to make some provision. However, if they are structured correctly, banks can both reduce debt on a property, reduce their property exposure and avoid potential future losses.

Many people in the industry expect banks to provide stapled finance, essentially new debt, to help such managers to buy existing assets. This is possible where there is still some equity in the deal but difficult if the property is already in negative equity.

The incentivisation of management is also key. Both borrowers and lenders are looking at structures where they can share any upside in value as well as take a management fee. For example, if the asset manager works a property and brings its value back above a certain level, any profit made upon its sale is shared by the bank and the manager, who will take a cut of between 10% and 50%.

Refinancing issues

"Amend and extend" is the phrase borrowers hope to hear when it comes to refinancing. According to most respondents, this is what will happen in most cases, with banks again scaling up fees to cover their increased costs of funding and the need to set more capital aside to cover the extended loans.

There is clear evidence that, thus far, banks have been extending loan maturities in preference to calling property loans in. The De Montfort survey (Maxted and Porter, 2009) showed that at the end of 2007, £22.7bn of UK property debt was due to be refinanced in 2009, with £21.5bn due in both 2010 and 2011 (see Table 1 below). The 2008 survey showed £43.8bn due for refinancing in 2009, with £32.6bn coming to maturity in 2010 and £31.5bn in 2011[6]. According to the report this was because loans due to be refinanced in 2008 and 2009 have been extended. This shows that banks are willing to extend loans (for a fee), but it also shows that if the general liquidity position of banks does not improve, a problem is potentially being stored up for the next few years, as there is no guarantee that liquidity in the banking sector will be any better next year than it is this year. There is also the fact that commercial property is not the only sector where there is a refinancing crisis – the same is true of private equity, and corporate debt.

Table 1: Property debt due for refinance

Year	2009	2010	2011
2007 Survey	£22.7bn	£21.5bn	£21.5bn
2008 Survey	£43.8bn	£32.6bn	£31.5bn

Source: Maxted and Porter, 2009

Foremost among the problems banks face when choosing whether to refinance a loan, is the issue of matched funding. Banks usually borrow short in the wholesale markets and lend long. This means they have their own refinancing needs to deal with, as well as those of borrowers. In some cases there can be a mismatch, and while banks might want to provide new debt for borrowers, they are simply unable to. The reopening of the Pfandbrief market will help German lenders in this sense by providing access to funds at relatively low margins. However, for many banks, dealing with their own liabilities is more important than the needs of borrowers.

[6] Maxted B, Porter. T. 2009. *The UK Commercial Property Lending Market: Year End 2009 research findings:* De Montfort University, p 9.

At the moment, it is virtually impossible for banks to borrow from each other for more than a year, two years at the most. This is because banks are still preserving capital to guard against potential loan losses. For this reason, banks are not generally extending property loans for more than a year or two leaving borrowers with less certainty on their funding.

The refinancing of loans is also contributing to a general stagnation of the investment market. The De Montford survey shows that £49.2bn of new lending was undertaken in 2008 with 55% coming through refinancing existing loans. This compares with £83.7bn of lending in 2007. The more refinancing there is to do, the less debt there will be for new deals.

The other major problem area for refinancing relates to the CMBS market. Here, loans have been sliced up and sold on to bond investors. As such, the exposure is no longer on banks' balance sheets. More than £8bn of loans that were securitised are due to be refinanced by the end of 2010, according to Fitch[7], with the same figure again due to be refinanced in both 2011 and 2012, according to Barclays Capital.

The issue here is that for such loans to be refinanced, a bank or group of banks looking to take on new exposure to commercial property needs to be found. This is nigh on impossible in the current market and unlikely to improve before the end of 2010, according to Fitch.

These CMBS loans need to find a home or bondholders will be forced to take action, and experience shows that discussions between large groups of bondholders are often less amicable and far trickier than those between a single borrower and lender. In the US one response to this seems to be an agreement to extend the period of the loans, hopefully to a point in time when the CMBS market will be more active. However this solution does not necessarily suit all groups of bond holders and is likely to lead to legal wrangles.

Morgan Stanley's property analyst team estimates that these problems with CMBS have the potential to trigger a further fall in UK commercial property values[8]. "There is a general feeling in the UK direct property market that prime yields have hardened somewhat during recent months," it said. "While we think this is probably true, we believe we have merely reached a temporary plateau rather than this cycle's peak yields. We believe that pressures from the CMBS market will be a driver for further UK yield expansion. In addition, we think this will also provide further upward pressure on yields in continental Europe."

Government intervention

There are two Government schemes which will have an effect on commercial property, namely the UK Treasury's Asset Protection Scheme (APS) and the Irish Treasury's establishment of the National Asset Management Association (NAMA). The details of both are yet to be finalised, but they offer two different solutions to the problems banks face.

The APS will guarantee losses on pools of assets selected by the two participating banks, RBS and Lloyds/Banking Group, and the government. Banks will absorb the first loss, at a level of around 10%, on assets protected by the scheme, and the government will cover the remaining 90% of losses. Banking analysts at Citi estimate that RBS will have around £56bn of construction and property loans covered by the scheme; Lloyds/HBOS is likely to have around £68bn covered[9]. Citi anticipates RBS will make a £4bn loss on property assets covered by the scheme, with Lloyds/HBOS

[7] Schmidt, M.,2009. *Quarterly European CMBS Performance Update Q1 09,* 8 April: Fitch Ratings

[8] Gysens, B. 209 *Property: Who will refinance CMBS*, 7 May: Morgan Stanley

[9] Citi 2009. *Royal Bank of Scotland Group: The Hidden Cost of Stabilisation,* 10 March and Rayner, T, *Lloyds Banking Group: What Government Asset Protection Scheme Means for Shareholders,* 13 March.

making a £22bn loss, but the government will absorb 90% of this loss. Under these arrangements, assets are likely to still be managed by the bank, rather than transferred and managed by the government or its advisors.

While the details are not finalised yet, the general consensus is that the APS will lead to banks holding more assets and working with borrowers rather than calling default. The banks are paying a premium for the scheme. It is thought that there is little benefit in banks calling default on loans covered by the scheme and flooding the market with unsaleable assets – and the government would resist this even if they wanted to.

The scheme is a five year program, and it is thought that banks will use the protection afforded against excessive losses to use all of that time to improve asset values as far as possible. The other benefit of the APS is the insurance it offers against excessive losses means that banks will not have to hoard as much capital and, as a consequence, will have more money to lend. The downside of this for the property industry is that there is little political imperative for this lending to be to property investors – the votes are won by helping homeowners and small businesses.

The Irish scheme differs in that the NAMA will buy up to €90bn of loans from Irish banks. These are mainly development loans but also include large investment loans of strategic importance. This focus is on Ireland but will include loans on UK property.

The main issue surrounding NAMA will be the price at which the loans are transferred. This is a problem that APS does not have to confront explicitly, as loans are not transferred but guaranteed. If the price paid by NAMA for the loans is too high, the taxpayer will be deemed to have overpaid, something no government wants to see happen. However, if assets are transferred at too low a price, banks will have to take a large write-down leading to yet further need for recapitalisation.

Once the loans are transferred, statements from the Irish Treasury imply there will be no going easy on borrowers, who will be chased for security. It remains to be seen how the re-pricing of these loans will affect the pricing of the assets they secure, and whether a low transfer price leads ultimately to a sell-off of assets at below market prices.

What stage have banks reached in dealing with their debt burden?

The general feeling is that most major lenders have now dealt with the wider corporate issues threatening their survival and are starting to put the structures in place to assess and improve the strength of their balance sheets. For this reason, action by banks, in any of the forms described above, is now set to increase.

Different banks will use different strategies. Some, such as RBS, Lloyds Banking Group and Barclays now have separate units to manage problem loans, with specific titles such as 'business support units'. Loans will be managed by these divisions in a pre-set manner. They will draw on the experience of property lending teams to work out the loans, which will be treated and accounted for separately until they are considered as performing again. If there is little prospect of this, they will be written off entirely.

By contrast, some other banks are proceeding on a more informal basis, with the existing lending teams (who are not doing any new lending currently) managing the problem loans.

A few banks are still fighting the wider fires necessary to ensure survival, and haven't yet started looking at loan books.

In situations where there are groups of lenders, especially when they are from different national jurisdictions, inertia generally occurs. Different banks tend to follow different accounting policies and this can lead to some lenders in a syndicate wanting to address a given problem while others want to let it lie.

However, in general, banks are now beginning the process of combing their books and identifying the action they need to take. Most banks are looking at the current situation as a five-year issue and beyond. The need to preserve profits and avoid undue losses is generating great caution. Those hoping to see a flood of property coming from the banks, creating a floor for prices and allowing trade in the investment market, may well be disappointed.

Box 1: Basle II, how it works and what effect it has on property

Basle II is a set of international accounting rules which indicate how much capital banks have to hold to mitigate against potential future losses. They are not hard and fast, and there is some leeway for banks in terms of how much capital they decide to put aside to mitigate against future losses, but as a general rule Basle II means that banks have to be careful how they treat riskier loans.

The bank needs to identify a risk weighted asset (RWA) assessment for every loan it makes. This is individual for each loan and for each bank, which has a complicated model to determine the RWA, part objective and part subjective. As a rough guide, RBS has a balance sheet of £2 trillion, and RWAs of £576bn.

Banks then have to put a proportion of their accumulated RWAs aside as reserve capital. For real estate investment loans of high quality (deemed to be 50% LTV or lower), this equates to 4% of RWA on a loan. As the LTV increases, this figure goes higher, up to 12%.

If a loan goes into default, a bank might have to put three or four times the RWA of a loan aside in the form of reserve capital –not generally viewed as an efficient use of capital. So banks cannot afford to extend LTVs indefinitely because the higher the LTV, the more reserve capital the bank has to be put aside. In such circumstances it might make more sense for a bank to cut its losses and sell the subject property.

One important point for property investors is that the Basle II rules state that regular valuations of loans have to be undertaken, normally at least once a year. Investors who think that the bank will avoid the problem by not calling for a regular valuation may be disappointed.

Box 2: RBS and Lloyds Banking Group: their property exposure and how they are dealing with it

With a combined £89bn of lending to UK commercial property (£45bn for RBS and £44bn for Lloyds Banking Group), these two banks make up 40% of all lending to UK property. They made the market in the good times and how they now deal with the workout of their loan books will be of systemic importance in the downturn. At both banks property makes up around 12% of all lending.

Most of these property loans will be covered by the UK Government's Asset Protection Scheme (APS). This means the banks will only have to bear a small proportion of any losses these loans to generate. While this could lead to the two banks foreclosing on a lot of loans and selling assets on cheaply given they would only have to take a small portion of the loss, it is understood that the Government will not countenance this, expecting Lloyds and RBS to work the problems out over the five year period of the scheme. Both banks have put in place similar structures to deal with this workout process, creating specialist teams that will work with loan origination teams to restructure loans.

At the time of its final results in February, RBS said that the property lending undertaken by its Global Banking and Markets (GBM) investment banking division had been deemed non-core and its £25bn loan book would be wound down over the next three to five years. It is understood that this does not apply to the £9bn of lending secured on UK property but, rather, RBS will withdraw from the overseas lending undertaken by this division. Stephen Eighteen, head of real estate for this division has now transferred (along with 100 of the 175 GBM real estate team) to the 'Global Restructuring Group' and will work on restructuring loans in the bank's UK loan book where necessary, with a view to reducing the exposure to property where possible.

At Lloyds Banking Group, the property lending team, headed up by Nick Robinson, has been restructured, with the biggest change being clearer divisions between the lending and private equity divisions, an area which contributed to the large property losses at HBOS.

At the time of its results, Lloyds reported that it considered around £22bn of the UK lending undertaken by HBOS to be 'high risk' and that these loans would be managed separately by the company's business support unit.

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