

Special topic – CRE-related risks

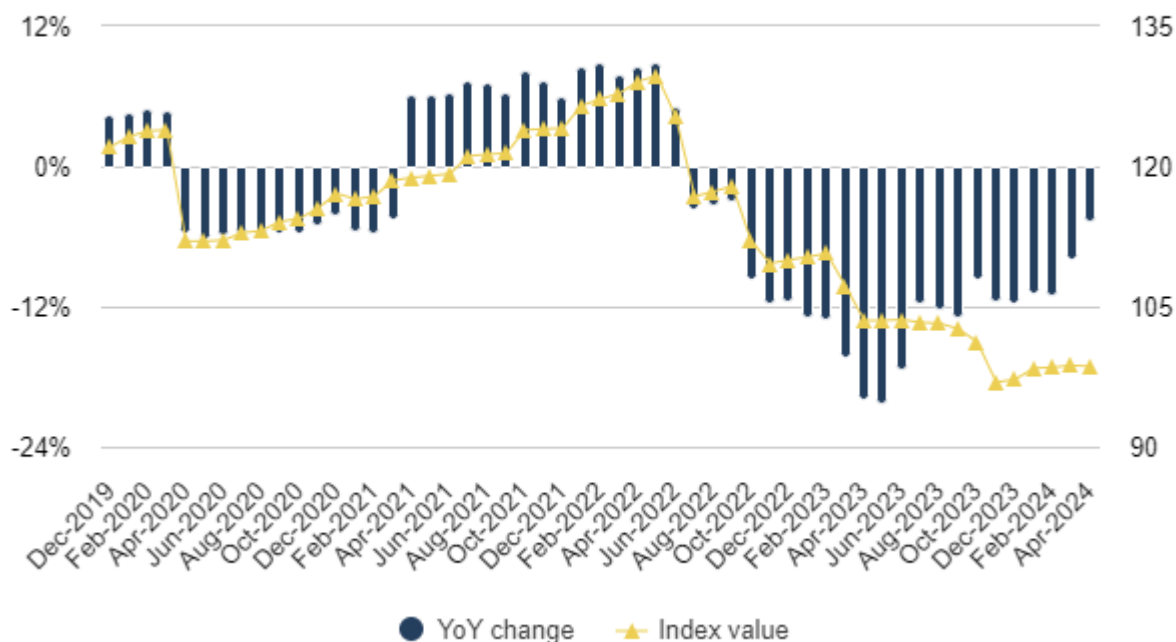
Structural and cyclical factors have caused cracks in commercial real estate markets

The pandemic had manifold impacts on societies, business, economies more broadly and many other parts of life. This includes the working environment which has changed significantly since the pandemic, affecting workplaces and offices. Significant changes in consumption have also occurred affecting shopping experience. Nearly all of these changes have had an impact on the CRE market. For example, office vacancy rates have increased in some European cities, as fewer employees commute to offices on a daily basis.^[1] At the same time, vacancy rates of retail shopping buildings also increased because of lower demand for physical stores. To add to these challenges, the CRE segment is also confronted with other structural changes including climate transition risks, with the pressure to move to more sustainable and more energy-efficient buildings. Cyclical developments have also had an impact on the CRE market. Tighter financial conditions and the abrupt increase in borrowing costs have made refinancing existing debt more challenging for CRE firms, while inflation has contributed to rising construction costs for new developments. Anecdotal evidence indicates an increased demand for bank loans from CRE firms to refinance or restructure their maturing debt, as access to capital markets financing became increasingly challenging.

As a result of these structural and cyclical changes, CRE firms have become increasingly motivated to raise capital through asset sales, often at a discount, either to manage refinancing risk or reduce pressure from leverage. Although the stabilisation of borrowing costs, lower inflation expectations and the flattening of risk-free yields may reduce the upward pressure on yield expectations for CRE assets (e.g. cap rates)^[2], spreads between CRE asset yields and risk-free yields remain at heights not seen since the monetary easing began in 2012. All these dynamics are mirrored in a correction in CRE prices. According to the IMF, CRE prices globally dropped by 12% in 2023.^[3] The adjustment in CRE prices was more intense in the US (ca. -23% YoY), while for Europe the correction was around 17%. Nevertheless, this decline seems to have slightly eased in the first quarter of 2024. Since its

last peak in May 2022 prices were down by around 25% (Figure 52).

Figure 52: Green Street pan-European commercial property price index *



Source: Green Street

Office, Retail, Industrial and Property Price Index. The index is calculated as the average of the index values for each sector, weighted by their respective share of the total commercial property market.

There are, however, large divergences in CRE pricing trends between countries, as well as asset classes and locations. The price corrections were, for instance, more pronounced in Germany and some other northern countries, whereas in other jurisdictions, including Spain and Slovenia, there were not any major corrections in CRE prices. Moreover, while the industrial premises segment showed a certain resilience, the office sector broadly suffered a particular price erosion due to lower income expectations, as a result of a sharp drop in demand, especially for non-prime assets. Property prices in the retail sector tend to be less affected than office prices, even though they show similar wide dispersion among countries (Figure 53).

Figure 53a: Year-on-year change in commercial property prices for selected countries *

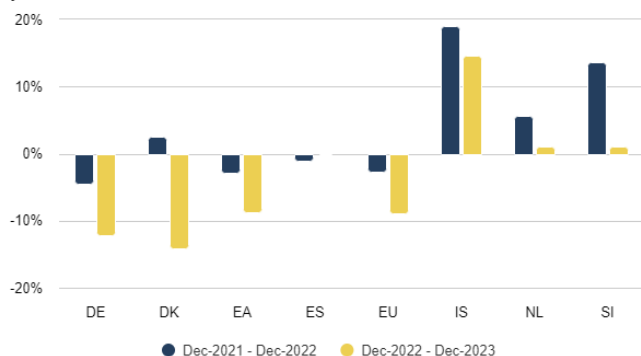


Figure 53b: Trends in office vs retail prices for selected countries *

Source: BIS Data Portal, ECB Statistical Datawarehouse (SDW), EBA calculations

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Publicly available data on the price of commercial real estate (CRE) is limited. The BIS Data Portal provides data on the price of commercial real estate (CRE) for selected countries. The data is based on the BIS Data Portal, ECB Statistical Datawarehouse (SDW), and EBA calculations.

Market data also suggests that the combination of cyclical and structural challenges faced by the CRE sector has caused European real estate investment trust (REIT) share prices to generally decline over the last two years, compared to pre-pandemic levels. The adjustments were significant across all REITs and reflected, at least in part, the trends observed in different CRE segments and in different countries. Nonetheless, in the first months of 2024, the share price of even those funds that had experienced a broader downward correction would appear to have stabilised at slightly higher levels, albeit at much lower levels from those prior to Covid-19 (Figure 54).

Figure 54: Share prices of selected European REITs *

Source: S&P Capital IQ

Publicly available data on the price of commercial real estate (CRE) is limited. The BIS Data Portal provides data on the price of commercial real estate (CRE) for selected countries. The data is based on the BIS Data Portal, ECB Statistical Datawarehouse (SDW), and EBA calculations.

Banks in the EU/EEA have considerable CRE exposures

EU/EEA banks have more than EUR 1.4tn of loans collateralised by CREs, which accounts for close to 23% of the total loans towards NFCs (or 11% of total loans if household loans are included). CRE-related exposures were less than EUR 1tn in 2014, signalling a more than 40% increase in these exposures within less than a decade (4.2% annual growth rate). Although loan growth had slowed post-pandemic (2.9% annual growth rate), and was even slower in 2023 (2.2%), it remained above other segments. This was the highest growth rate for NFC-related exposures. This might indicate that, despite banks' tightening of lending standards, the sector has stepped up to fill to some extent the funding gap that CRE firms

The performance of CRE loans is not only defined by the type of the underlying asset, such as office or retail etc., but is also dependent on its location. Although the correction in European CRE prices has been notable, elsewhere it was even more acute, as shown above. More than EUR 200bn of CRE-related exposures were towards non-EEA-domiciled counterparties. German, Spanish and Dutch banks reported the highest non-EEA exposures. Of these, EUR 75bn were towards counterparties domiciled in the US, and EUR 30bn to UK counterparties. German banks reported more than EUR 50bn US CRE exposures, while Dutch banks reported around EUR 10bn. These were concentrated in a small number of banks, exacerbating the potential idiosyncratic risks. A number of these banks have increased markedly their provisioning levels against these exposures in the last quarters (Figure 57).

Figure 57: Loan collateralised by CREs towards the country of domicile of counterparty – December 2023

Source: EBA supervisory reporting data

Loan-to-value ratios provide an initial shield against collateral valuation correction, yet banks should ensure accurate and up-to-date valuations and prudent risk management

The banks that lend to CREs rely on the value of respective properties as collateral to protect them from loan losses when the lenders default. However, if the value of the CRE collateral drops significantly, the chances for a full loan recovery might become worse and may feed into an adverse loop. As such, the effect of worsening conditions in the CRE market on banks goes beyond their direct exposures to CRE firms only.

One important metric used to assess the risk associated with CRE loans is the loan-to-value (LTV) ratio. The LTV ratio represents the percentage of the loan amount relative to the appraised value of the property. CRE loans often come with a decent cushion against property price declines due to their relatively low LTV ratios. This protective cushion is especially valuable during economic downturns or market corrections. EU/EEA banks reported that approximately 63% of CRE exposures have an LTV of less than 60%. These loans provide a buffer for banks in case of adverse market conditions. Yet, close to EUR

160bn of CRE loans have an LTV of more than 100%. This means that the loan amount exceeds the appraised value of the property. The highest concentration of 'high LTV values' is reported in central and eastern European countries. These loans pose a greater risk to banks if property prices decline and therefore banks need to particularly closely monitor their exposure to high LTV loans, especially in regions where such loans are prevalent (Figure 58).

Figure 58: Loan-to-value ratios of loans collateralised by CREs by country and total CRE loans – December 2023

Source: EBA supervisory reporting data

Given the limited visibility, a number of banks particularly exposed to the sector have provided some transparency with more detailed breakdowns of their CRE exposures, e.g. into the different sub-segments, like office, retail, hotels, warehouses, etc., showing that exposures towards office properties seems more prominent rather than retail exposure. As these exposures could potentially lead to elevated risks associated with collateral valuation, analysis of these risks has become a priority for supervisors. For instance, in the August 2022 edition of its Supervision Newsletter, the European Central Bank (ECB) highlighted collateral valuation as an area of concern for various banks. On-site inspections revealed issues related to the updating of appraisal reports in accordance with the Capital Requirements Regulation (CRR) and ad hoc revaluations based on changing market conditions. The ECB also expressed concerns that valuation methods and inadequate parameters could result in significant overstatements of asset values.^[4] This underscores the importance of robust risk management practices in the CRE sector, particularly when it comes to collateral valuation, to ensure accurate assessments and mitigate potential risks.

As interest rates have moved to a higher level in the current macroeconomic situation, CRE firms that relied on floating-rate financing structures are exposed. The higher interest rate environment affects negatively the interest coverage ratio (ICR), an indicator that measures how comfortably the borrower can pay interest with their operating income (on rate expectations see Chapter 1). According to RAQ data, about 45% of the CRE loans have a fixation period shorter than one year and will quickly reprice, while only 25% have a fixation period longer than five years. In addition, the maturity structure of the loans could

sometimes mask their underlying risks. For example, a significant share of CRE loans are bullet loans.^[5] These are loans in which the repayment of the principal (and sometimes with the interest too) of the loan is at its maturity.^[6] The challenge of offsetting higher financing costs is also dependent on the possibility to increase rents for related property. CRE firms have to manage debt service and deal with market uncertainties at the same time.

Figure 59: Share of outstanding CRE loans repricing in less than 12 months

Source: EBA Risk Assessment Questionnaire

Asset quality indicators send mixed signals on the performance of CRE exposures

Despite the elevated uncertainties in the CRE segment, EU/EEA banks report that asset quality of their CRE loans has so far remained solid. In December 2023, EU/EEA banks reported EUR 58bn of NPLs. Although the volume of NPLs dwarfs the one reported nearly a decade ago (EUR 211bn in December 2014), it has increased by more than 12% in the last year (EUR 52bn in December 2022). The NPL ratio was at 4.1% in Q4 2023, down from 22% in 2014, but marginally higher than a year ago. At the outset of the pandemic the share of CRE loans allocated to Stage 2 rapidly increased. In December 2023, EU/EEA banks reported more than EUR 240bn in IFRS 9 stage 2 (+8.6% year-on-year increase). In the last quarter of 2023 alone, EU/EEA banks increased them by more than EUR 10bn, signalling a rising pace in this trend. The share of stage 2 allocation was last reported at 17.8% (16.7% in December 2022) (Figure 60).

Figure 60: Trends in NPL and IFRS 9 stage 2 allocation volumes and ratio of CRE exposures – December 2014 to December 2023 *

Source: EBA supervisory reporting data

* Stage 2 data for CRE only available since 2020, for which reason there is no earlier comparison available.

The trajectory of non-performing commercial real estate (CRE) loans has varied significantly across countries. Banks in southern European countries have notably decreased their CRE NPLs over the past five years, and continue to clean up their balance sheets, not only through organic means (e.g. cures) but also through non-organic means (e.g. securitisations, NPL sales, etc.). Still, the highest NPL ratio in CREs is reported by Portuguese and Greek banks (8.9% and 8.7% respectively). However, banks in both countries reported a

substantial decrease in the NPL ratios compared to a year earlier. In contrast, French banks reported a slight increase, while German banks have encountered a more substantial rise, even though it started from historically low levels. The latter's CRE NPL ratio surged to 4.8% in the last year (2.1% in December 2022). Other countries such as Austria and the Netherlands reported a meaningful increase, too.

The disparity between countries in the stage 2 allocation of CRE loans is even more pronounced. Country averages range from as low as 2.3% (Liechtenstein) to up to 36.9% (Ireland). German followed by Czechian banks increased the most the allocation of CRE loans to stage 2 during the last year. In both countries the allocation to stage 2 is one of the highest, exceeding 20%. Yet, similarly to the reported NPL ratios, despite the overall worsening conditions in CRE markets banks in several countries reported lower stage 2 allocation than in December 2022. This highlights the heterogeneity of the performance of CRE assets (Figure 61).

Figure 61: NPL and IFRS 9 stage 2 allocation ratio by country for CRE exposures – December 2022 and December 2023

Source: EBA supervisory reporting data

During 2023 NPL inflows exceeded outflows for CRE exposures, albeit marginally. EU/EEA banks reported NPL inflows of EUR 29bn and outflows of around EUR 21bn. The reported net inflow of EUR 8bn was in contrast to the net outflow reported in the previous three years. The net inflow increase was mainly attributed to German and Dutch-domiciled banks (Figure 62).

Figure 62a: Trend NPL inflows/outflows of EU/EEA banks related to CRE exposures

Source: EBA supervisory reporting data

Figure 62b: NPL inflows/outflows related to CRE exposures by country in 2023

Source: EBA supervisory reporting data

Banks anticipate further asset quality deterioration of CRE loans across all regions according to the RAQ results. This is especially true for central European countries (80%) and the Nordics (60%). Meanwhile, more banks than before expect the asset quality of CRE loans to stay the same for most regions, +20 p.p. on average, suggesting a possible easing of the asset quality decline (Figure 63).

Figure 63: Asset quality expectations for CRE loans by region

Source: EBA Risk Assessment Questionnaire

Provisions and targeted macroprudential measures can protect banks from a further downturn in CRE markets, as does active portfolio management

EU/EEA banks have set aside quite sizeable provisions to cover non-performing CREs. In total, banks had provisions against CRE loans of EUR 31bn, of which EUR 19bn were against NPLs. Provisions were slightly lower than a year earlier, although there was a substantial differentiation in the change of provisioning levels by country. For example, German banks increased their provisions against CRE loans by close to EUR 1.7bn (+58% YoY). Banks in other countries, mainly from the Nordics or eastern Europe, have also increased their provisioning levels. By contrast, banks in southern Europe decreased the provisioning levels against CRE exposures substantially. For instance, Italian banks decreased provisioning levels by more than EUR 1.2bn (or -15%), mainly driven by provisions against NPLs.

The weighted coverage ratio of CRE loans of EU/EEA banks stood at 33.5% as of December 2023, while for performing only loans it stood at 0.9%. NPL coverage ratio was lower than a year earlier (37.9%), while the coverage ratio for performing loans remained the same. Coverage ratios differ widely across countries. Levels of provisions are widely dependent on the underlying asset; therefore, a certain degree of divergence can be expected. Yet some countries report very low coverage ratios against NPLs. These ratios range between 13% and 59.8%. Similarly, for performing loans the provisioning levels are as low as 0.1% of total performing CRE loans and up to 5.1% (Figure 64).

Figure 64: Coverage ratios of performing and non-performing CRE loans by country – December 2023

Source: EBA supervisory reporting data

The strong capital and liquidity position of EU/EEA banks should on average make risks stemming from CREs for the banking sector manageable. In the 2023 EU-wide stress test conducted by the EBA, larger institutions demonstrated resilience against an assumed scenario that included a 30% downturn in CRE markets.^[7] There are, however, idiosyncratic risks which need to be closely monitored by banks and their supervisors. These

idiosyncratic risks have prompted authorities across Europe to take precautionary measures to safeguard financial stability. For example, macroprudential authorities in Europe have put in place capital-based measures against real-estate-related cyclical risks such as risk-weighted floors on commercial real estate exposures implemented in Sweden or a higher risk weight for CRE exposures set in Latvia.^[8] In addition to these, sector-specific systemic risk buffers are under discussion and being proposed. For instance, in Denmark the Systemic Risk Council has recommended the introduction of a 7% sector-specific systemic risk buffer for bank exposures to real estate companies.^[9] By implementing such measures, regulators seek to mitigate risks associated with CRE and maintain a robust financial system.

[1] See [Savills research – European Office Outlook – December 2023](#).

[2] Cap rate can be calculated by dividing a property's net operating income by its asset value. It provides an assessment of the yield of a property over one year.

[3] See [IMF: Financial stability and risks – April 2024](#).

[4] See the [ECB's Supervision Newsletter: Commercial real estate: connecting the dots \(europa.eu\)](#).

[5] See [Scope Rating's report on extension risks of CRE loans in commercial mortgage-backed securities \(CMBS\) from May 2024](#), according to which refinancing for CRE loans has increased this year.

[6] See, for instance, the [article 'Commercial real estate: connecting the dots' in the ECB's Supervision Newsletter from August 2022](#), according to which a big share of CRE loans have major instalments that are due at maturity.

[7] See [EU-wide EBA stress test July 2023](#).

[8] See, for instance, the [notification for the measure applied in Latvia](#) from December 2023.

[9] See the [ESRB's Overview of national capital-based measures](#) (regularly updated).