(Re)Emerging Funding Gap in European Commercial Real Estate Debt

Stricter bank regulation and rising rates will expand the market opportunity for alternative lenders.

Executive Summary

Banks' existing regulatory regime, combined with the current rising rate environment, are expected to have a material negative impact on bank lending activities and result in a renewed funding gap for commercial real estate debt in Europe. Alternative lenders, such as AB, are well placed to capture significant market share in such an environment.

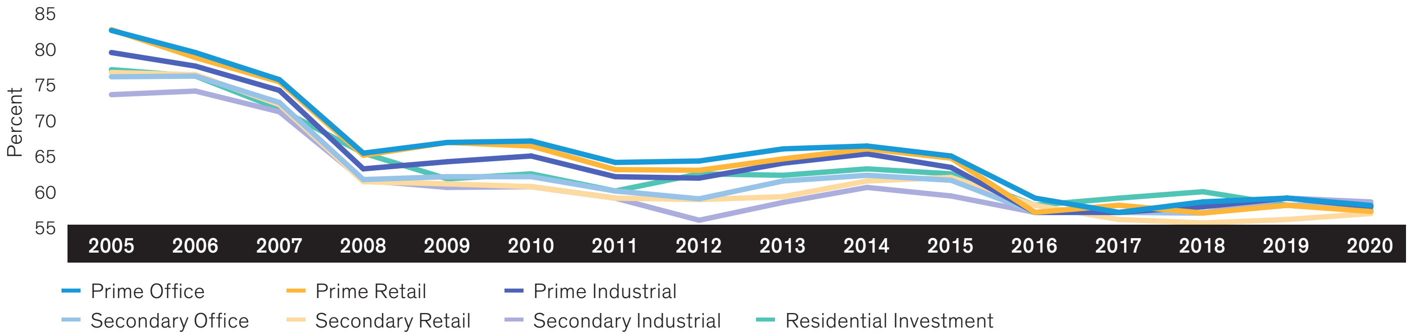
A Touch of History

In the wake of the 2008 global financial crisis ("GFC"), European regulators drastically increased the amount of regulation that applied to lending activities at banks. This created a significant funding gap in the market, as prior to the GFC banks accounted for the vast majority of all lending activity to commercial real estate in Europe. In 2012 Morgan Stanley famously estimated a €400–700 billion funding gap in Europe, driven by banks' need to deleverage their balance sheets. This was the catalyst for alternative lenders entering the market.

As a result of this increased regulation, banks could no longer take the same degree of risk as they did prior to the GFC. For commercial real estate loans, this meant drastically reducing the loan to value ("LTV") extended to borrowers. As shown above, the average LTV of real estate loans in the United Kingdom fell from a high of 75-85% LTV pre-crisis to more modest levels of 55-65% post-crisis.

AVERAGE LTV BY SECTOR

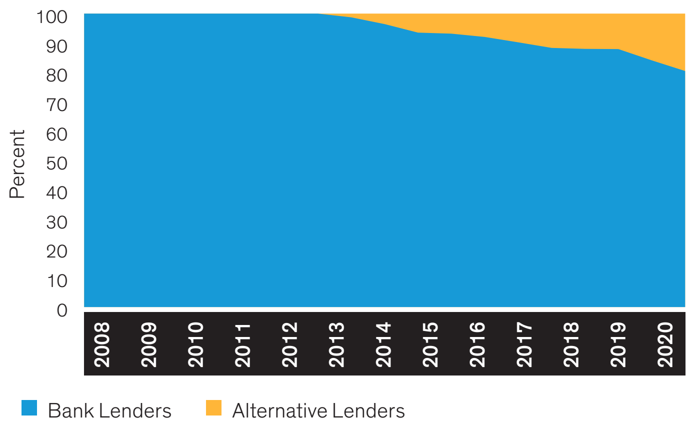
UK



As of 4Q 2020 | **Source**: Bayes Business School and AB

PERCENT OF TOTAL OUTSTANDING LOAN BOOK VALUE BY LENDER TYPE

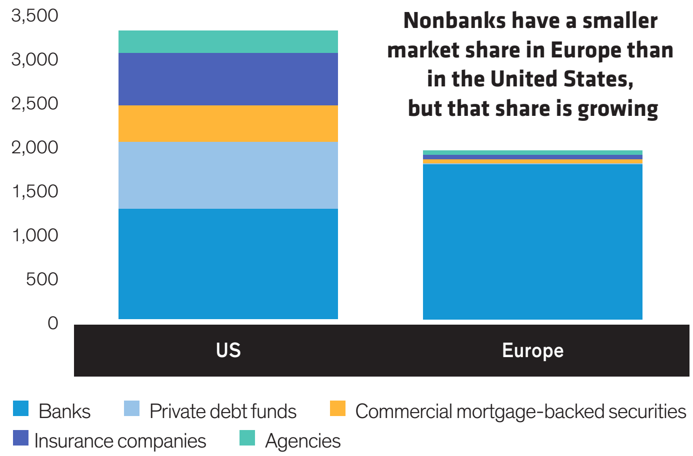
UK



As of 4Q 2020 | **Source**: Bayes Business School. Cumulative data shown as a percent of total.

SIZE COMPOSITION OF CRE DEBT MARKET

€ Outstanding Loans



As of September 2021 | **Source**: Mortgage Bankers Association, Bayes Business School, IREBS, IEIF, PwC Strategy&, Banque de France, AFME, PGIM Real Estate

Post-GFC regulators have also increasingly encouraged banks to not only assess the riskiness of a loan based on LTV, but also on cash flow and the ability of the borrower to service the loan's interest costs—commonly referred to as a loan's debt service coverage ratio ("DSCR"). This was a prudent move, but one which is expected to cause stress for banks and borrowers in a rising rate environment. We address this point in more detail below (*Table 1*).

As a result of increased regulation in Europe, alternative lenders began to capture market share from banks in 2010. In the UK, non-bank lenders went from nil to +10% market share by 2020, as shown above. Continental Europe has followed a similar, albeit more gradual trajectory. By 2020, the European market had returned to a level of normalcy and the funding gap had largely disappeared.

While the structural shift in the European commercial real estate debt has been at play for over a decade, the market remains overly reliant on banks for liquidity. In a mature market such as the United States, banks represent less than half of the total market. Whereas in Europe, banks still account for nearly 90% of all lending activities. As a result of this over dependence, when the banking market is impacted, whether it be a shock like COVID-19 or sudden rising rates, the consequence for the overall market can be significant.

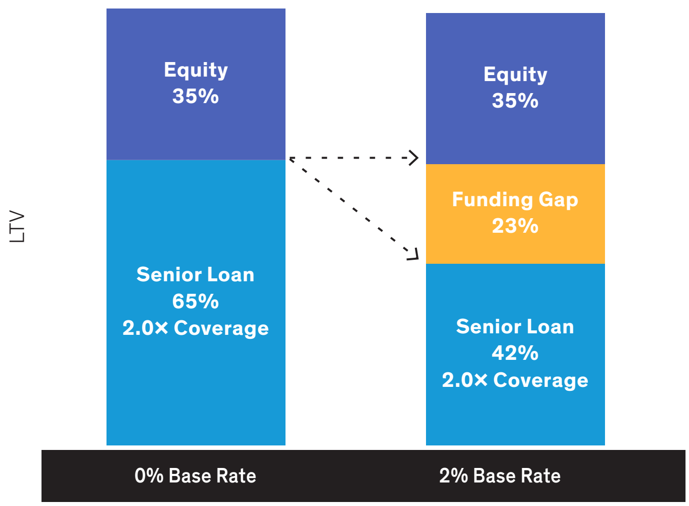
Back to the Future

Fast forwarding to today's rising rate environment and the heightened focus on debt service coverage by banks, there are signs of a new funding gap emerging in Europe. The catalyst behind this is fairly straight forward. All other things equal, as interest rates rise, a loan's DSCR falls. Lower DSCRs can result in a loan being perceived to be riskier and thus attract higher regulatory capital charges. Therefore, as loans reach maturity and come up for refinancing, banks will either need to (i) reduce loan proceeds to maintain a similar DSCR profile, (ii) lend the same proceeds and hold more regulatory capital against the loan, reducing the bank's ability to lend elsewhere, or (iii) encourage the borrower to refinance the loan away from the bank. Each of these scenarios result in the bank providing less liquidity to the market.

Table 1: Impact of Base Rates on Credit Metrics

Market Value of Property	100.0	100.0
Net Income of Property	5.0	5.0
Net Initial Yield (percent)	5.0	5.0
Loan LTV (percent)	65.0	65.0
Loan Amount	65.0	65.0
Loan Base Rate (percent)	**0.0**	**3.0**
Loan Margin	2.8	2.8
Loan Amortisation	1.0	1.0
Total Debt Service	3.8	6.8
Loan DSCR	**2.0×**	**1.1×**
Target Loan DSCR		2.1×
Implied Loan Amount		36.0
Implied LTV (percent)		**36.0**

FUNDING GAP EMERGENCE



As of 2022 | **Source**: AB

We have shown, in Table 1, how a 3% increase in base rates can erode the credit metrics of a loan. In the below example, at 0.0% base rates, a loan would produce a DSCR of c. 2.0×—an attractive coverage level for a bank. However, that same loan refinanced at 3% base rates, would produce a DSCR of just c. 1.1×—a much riskier proposition for a bank. If the bank wanted to avoid allocating higher regulatory capital to the loan upon refinancing and therefore seeks to match the historic DSCR of 2.0×, it would mean reducing loan proceeds from 65% to 36% LTV, a 29%-point reduction (*chart above*).

If we extrapolate this to the wider market, the impact of rising rates quickly becomes apparent. European commercial real estate debt is a €1.8 trillion market. If just 5% of the market per year is impacted by this shortfall, then the 29% funding gap would translate to nearly a €26 billion annual shortfall. Should rates rise further, this quantum will quickly grow.

Will Banks Pretend and Extend?

Post-GFC, there was not as much distress coming out of the banks as many market participants expected. Despite high LTVs and falling market values, banks often chose to retain higher risk positions on their balance sheet rather than dispose of them via non-performing loan pools or similar instruments. This commonly became known as *'Pretend and Extend'*, whereby banks would extend the maturity of existing loans and allow borrowers to retain control of the underlying property. A key reason that banks took this approach, and regulators allowed it, was that it occurred in a falling interest rate environment. As loans reached their initial maturity and associated interest rate hedges expired, there was more free cash flow available after servicing interest to apply towards paying down the loan balance. This allowed banks to sweep the free cash flow and reduce the risk profile of the loan over the course of the extended term. This approach, compared to the alternative of potentially having to enforce upon the underlying collateral and/or hold a defaulted loan on balance sheet, was an obvious choice and a 'win-win' for all involved.

Reflecting on the current environment, we do not anticipate that banks, nor regulators, will have the same favourable outlook toward utilising a *'Pretend and Extend'* approach. The reason for this is simple—in a rising rate environment, the amount of cash flow required to service a loan is likely to increase, not decrease, if its term is extended. This is because the borrower would need to enter a new interest rate hedge for the extended term at a higher rate. This higher rate would consume more free cash flow and thus lead to worsening credit metrics in an extended period. In other words, the perceived riskiness of an extended loan is likely to increase as opposed to decrease in a rising rate environment. As a result we expect that banks, influenced by regulators, will be under greater pressure in the current environment to resolve legacy loan issues in a timely and proactive manner.

Just a Mezzanine Opportunity?

No. While we believe that the demand for capital from alternative lenders will increase materially in the current environment, we do not believe that mezzanine debt alone will address the gap. In practice, the funding gap will be filled by a combination of (i) common equity injections (ii) mezzanine and preferred equity injections (iii) new whole loans and (iv) property disposals. In a world of scarce regulatory capital, banks are likely to concentrate their new lending activities on the highest quality opportunities. When bank regulatory capital and balance sheets have been allocated, the marginal borrower will need to find liquidity elsewhere. This is favourable for alternative lenders as the quality of that marginal borrower is generally still very high. As a result, we anticipate that alternative lenders will help to address the funding gap by providing a host of capital solutions that will range from conservative whole loans through to more opportunistic subordinate debt and preferred equity.

Conclusion

Alternative lenders feed on the periphery of bank appetite—as banks curtail their lending volumes and activities, alternative lenders such as AB are well positioned to capture increased market share. We expect that the abrupt shift from a low to a rising interest rate environment will create considerable headaches for banks and lead to a significant broadening of the opportunity set for alternative lenders. Debt investors can benefit from enhanced returns as base rates and risk premia increase, while also benefiting from significant 3rd party equity cushions that help to insulate their capital against value stress. In short, the next few quarters should be a very attractive time to be a well capitalised alternative lender. Stay tuned.

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