

EURO AREA COMMERCIAL PROPERTY MARKETS AND THEIR IMPACT ON BANKS

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Euro area commercial property markets and their impact on banks

Developments in commercial property markets are of importance to euro area banks mainly because commercial property loans represent a considerable part of many banks' assets and lending for commercial property tends to be more volatile than many other types of lending. Conditions in commercial property markets have deteriorated in most euro area countries since 2008 and negative developments have intensified in recent quarters. This article provides an overview of commercial property markets in the euro area, discusses some recent developments in the markets and presents some data on euro area banks' commercial property lending exposures.

I INTRODUCTION

History has shown that disorderly adjustments in commercial property markets can play an important role in financial crises, most notably in the Nordic countries and in the United States in the early 1990s, as well as in some Asian economies in the late 1990s.

Developments in commercial property markets can have important implications for financial stability via a number of channels.¹ First, a significant proportion of many euro area banks' assets are comprised of loans extended for investment in commercial property. A fall in commercial property prices and rents weakens the property companies' earnings capacity and thus their ability to service debt, and it also lowers the value of collateral for mortgages. In the event of a borrower being unable to pay, the value of the collateral may then have to be realised for less than the amount of the loan. Second, loans for commercial property investment tend to be more volatile than many other types of lending in banks' loan portfolios. Third, adjustments in commercial property prices can also have an indirect impact on banks' balance sheets in that they have negative implications for the real economy. Fourth, decreases in commercial property prices can have a direct impact on banks' balance sheets as they might be property owners. Fifth, institutional investors, such as insurance companies, pension funds, hedge funds and private equity firms, all of which fulfil varying but important functions in the financial system, sometimes have large investments in commercial property markets, both directly and indirectly.

Section 2 provides an overview of commercial property markets and companies in the euro area.

Section 3 discusses recent developments in, and the outlook for, euro area commercial property markets and companies. Section 4 analyses euro area banks' lending exposures to commercial property, given that this can be considered to be the main channel through which adverse developments in commercial property markets can have a negative impact on financial stability. Section 5 concludes.

2 OVERVIEW OF COMMERCIAL PROPERTY MARKETS AND COMPANIES IN THE EURO AREA

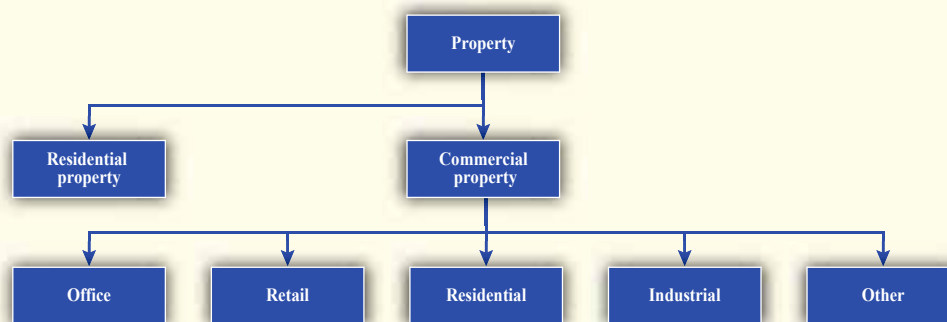
Commercial property encompasses a variety of income-producing property, such as office buildings, restaurants, shopping centres, hotels, industrial parks, warehouses, factories and residential property owned by, for instance, a property company (see Chart 1).

Commercial property companies can be defined as companies that are predominantly engaged in the ownership, development and building of income-producing real estate, including the renting and operating of and the trading in such property.

Property used for residential purposes, such as multi-household dwellings, is labelled as commercial property when it is owned or being developed for commercial purposes, for example by a property company or an institutional investor.

¹ These risks have also been highlighted in ECB, "Commercial property markets: financial stability risks, recent developments and EU banks' exposures", December 2008, and ECB, "Commercial property investment and financial stability", *Financial Stability Review*, December 2007.

Chart 1 Types of property



Note: Property used for residential purposes is labelled as commercial property when it is owned or being developed for commercial purposes.

THE SIZE OF COMMERCIAL PROPERTY MARKETS IN THE EURO AREA

It is difficult to accurately estimate the size of commercial property markets in the euro area or globally because of the fragmented and somewhat opaque nature of the markets in many countries. Some estimates put the overall size of euro area commercial property markets at around €4.4 trillion in 2008 (see Chart 2). Within the euro area, Germany has the biggest market, with a share of 28% of the total euro area market, followed by France (20%) and Italy (17%).

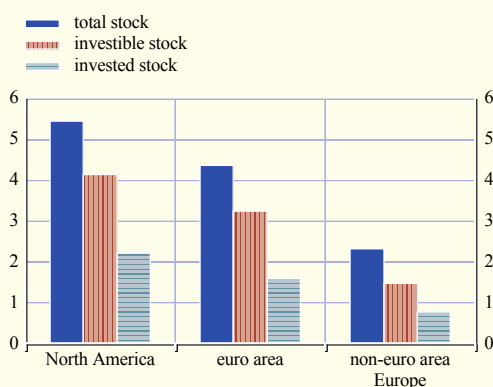
The total commercial property stock can be divided into several categories in order to

reflect to what extent the property is, or can be, bought and sold by investors (see the table). The size of the “investible” part of the euro area market is estimated to be about €3.2 trillion, or 74% of the total market (see Chart 2). The investible part does not make up the entire market owing to the fact that not all properties can be sold by the owners, such as some government-owned buildings, e.g. hospitals, schools and similar properties.

Within the investible part of commercial property markets, it is possible to separate the share that is “invested”, i.e. owned by professional investors and not owner-occupied.

Chart 2 The size of commercial property markets in Europe and North America

(2008; EUR trillions)



Sources: DTZ and RREEF Research.

Investible and invested commercial property stock

“Investible” property stock = share of **“total property stock”** of investment grade quality which can be sold to professional investors or which is currently owner-occupied, but could become available for sale later.

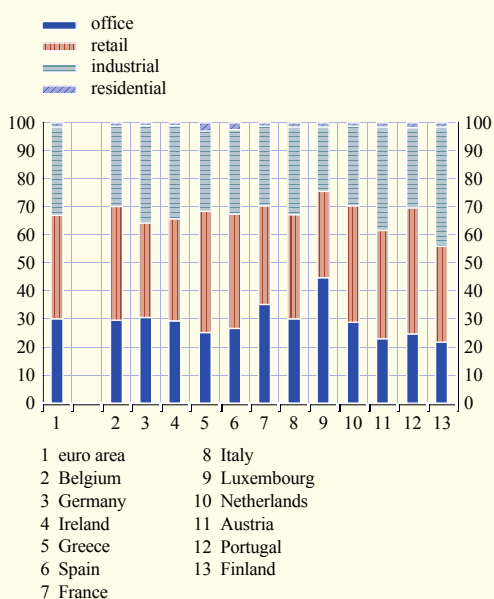
“Invested” property stock = share of **“investible property stock”** which is not owner-occupied, and thus owned by professional real estate investors for investment purposes.

This share corresponds to the relatively more “liquid” stock in the commercial property market. The overall size of the invested market in the euro area is estimated to be around €1.6 trillion, or 37% of the total market (see Chart 2). This share varies considerably across countries, ranging from 14% to 80%, reflecting the varying degrees of owner occupation across euro area countries.

Beyond the variation in the size of markets within the euro area, there are also differences within markets in terms of the relative size of each of the main commercial property types, which mainly include offices, retail space and residential multi-family houses. In euro area countries, the retail segment is generally the largest, making up about 37% of the total. Office and industrial property each account for about 30% (see Chart 3).

Chart 3 The size of different types of commercial property in the euro area and selected euro area countries

(2008; percentage of total)



Sources: RREEF Research and ECB calculations.

PROPERTY COMPANIES IN THE EURO AREA

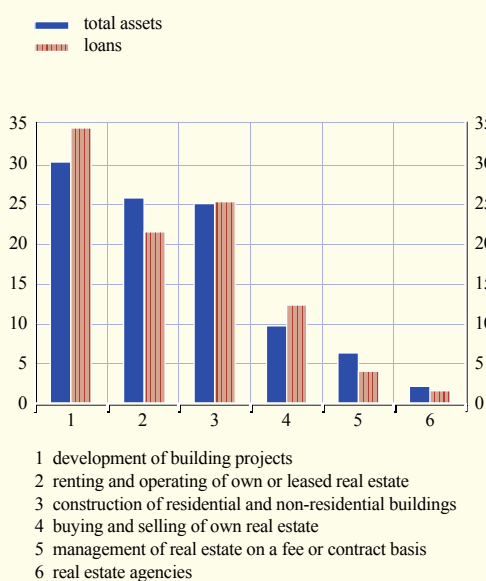
The business activities of property companies in the euro area span a variety of areas related to real estate. The definition of a property company is thus a rather broad concept.

Property companies engaged in developing², renting and operating, and/or constructing buildings hold more than 80% of the total assets of property companies in the euro area. Companies buying and selling properties account for an additional 10% and management companies and real estate agencies make up the remaining share (see Chart 4). Needless to say, many property companies are active in several areas.

- 2 This includes the development of building projects for residential and non-residential buildings by bringing together financial, technical and physical means to complete the construction of buildings for later sale.

Chart 4 The relative size of different types of commercial property companies in the euro area

(2008; percentage of total)



Sources: Bureau van Dijk (Amadeus) and ECB calculations.
Notes: The data cover almost 31,000 companies in the euro area. The classifications are in line with the Statistical Classification of Economic Activities in the European Community.

The relative size of these companies when measured by total loans broadly follows that of the total asset distribution (see Chart 4). The biggest credit exposures for banks are to property developers and property construction companies, although the size of the different property sectors varies significantly across euro area countries. It is, however, difficult to obtain data for these segments of banks' commercial property lending as they are often grouped together under the broader category of "construction", which also includes lending to railway and motorway builders, for example.

3 RECENT DEVELOPMENTS IN, AND THE OUTLOOK FOR, COMMERCIAL PROPERTY MARKETS IN THE EURO AREA

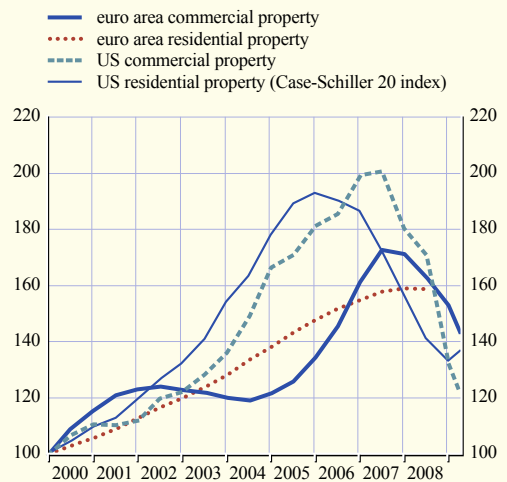
CAPITAL VALUES

Commercial property values – i.e. commercial property prices adjusted downwards for capital expenditure, maintenance and depreciation – in the euro area have been more cyclical than residential property prices during the last decade (see Chart 5). This is mainly because commercial property values follow the business cycle more closely than residential prices. In addition, commercial property values are more volatile because they are marked down when rents soften or vacancies rise, even if no transaction has taken place. Residential property price data, on the other hand, are based on actual transactions. This, together with the fact that homeowners are more likely than commercial property occupiers to stay in their property even if the value thereof declines, leads to prices for residential property being, in general, less volatile. Commercial property lending is, therefore, often a more volatile component in banks' loan portfolios than residential property lending (see Section 4).

While residential property prices, on average, stabilised in the euro area during 2008, the capital values of commercial property have been declining since the beginning of 2008 (see Chart 5).

Chart 5 Commercial and residential property prices in the euro area and the United States

(H1 2000 – Q3 2009; index: H1 2000 = 100)



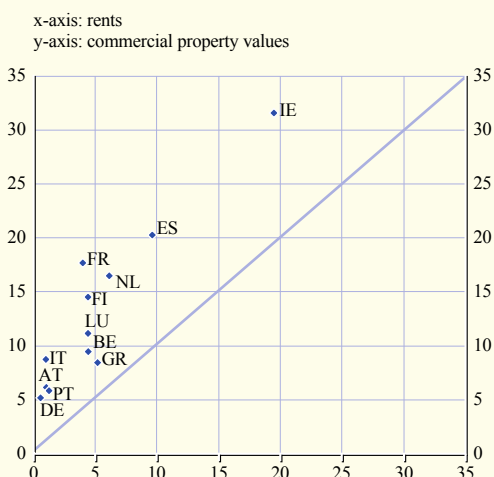
Sources: ECB, Jones Lang LaSalle, Standard and Poor's and Bloomberg.
 Note: The data for commercial property are "capital value changes", i.e. prices net of expenditure, maintenance and depreciation.

The developments in the euro area during the last decade can be compared with those in the United States, where both commercial and residential property prices witnessed a more pronounced increase between 2000 and 2006/07, which was then followed by a more distinct correction (see Chart 5). While US residential property prices reached a peak in the first half of 2006, commercial property prices continued to increase up until the second half of 2007, but the corrections in both markets have, up to now, been of a similar magnitude.

In theory, commercial property prices should mainly be driven by rent developments, since the net present value of future income streams should determine the value of a commercial property. Indeed, there was a positive relationship between commercial property value changes and rent growth during the period of high capital value growth between 2004 and 2007 (see Chart 6). However, the fact that commercial property values in most countries rose more than rents suggests that price increases might, in some cases, have

Chart 6 Changes in commercial property capital values and rents in selected euro area countries

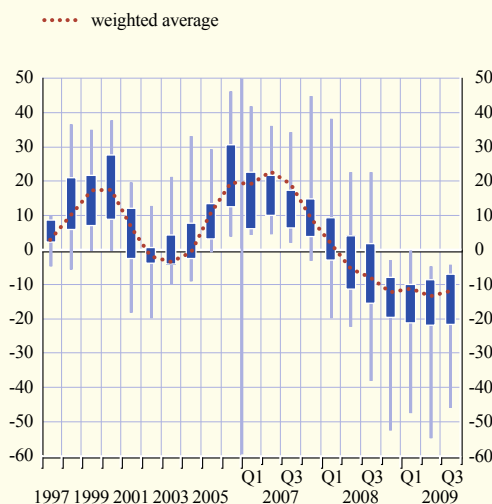
(average percentage change per annum for the period 2004-2007)



Sources: Jones Lang LaSalle, Eurostat and ECB calculations.

Chart 7 Changes in the capital value of prime commercial property in euro area countries

(percentage change per annum; maximum, minimum, interquartile distribution and weighted average)



Source: Jones Lang LaSalle.

Note: Data for Cyprus, Malta, Slovakia and Slovenia are not available.

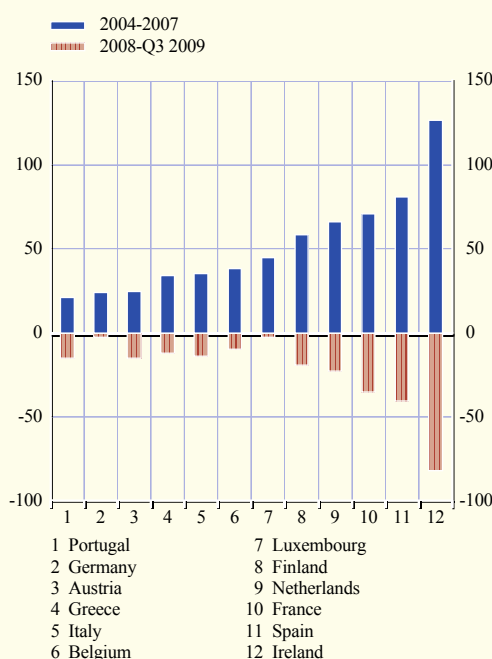
been driven by factors other than economic developments, for example, by speculative activity fuelled by a hunt for yield. Such activity was also driven by the relatively low interest rates and sometimes lax lending standards of banks.

The deterioration in euro area commercial property markets since 2007 has been rather broad-based and all euro area countries for which data are available have been recording declines in the capital values of prime property (modern buildings in attractive locations) since the fourth quarter of 2008 (see Chart 7). On average, year-on-year price declines have hovered between 10% and 13% in recent quarters. However, this varies widely across countries, with annual price decreases of 50% in some countries and more modest price declines in other countries.

In general, the countries that recorded the steepest price increases between 2004 and 2007 are the ones that have been witnessing the largest corrections since the beginning of 2008 (see Chart 8).

Chart 8 Changes in commercial property capital values in selected euro area countries between 2004 and 2007, and 2008 and Q3 2009

(cumulative percentage changes per annum)



Sources: Jones Lang LaSalle, Eurostat and ECB calculations.

RENTS

Rents have held up better than capital values in recent quarters and were still increasing, on average, in the euro area in the first quarter of 2009 (see Chart 9). It should be noted, however, that rents are often fixed for one or several years and demand factors for commercial property space that have an impact on rents thus only pass through to actual rent developments with a lag. Furthermore, rent developments have varied across euro area countries, with some countries recording declining rental values since the beginning of 2008 (see Chart 9).

In the third quarter of 2009, commercial property rents in the euro area declined by about 4% year on year. Rents fell by almost 10% for office space, while, on average, remaining flat for retail space. However, developments across countries have been heterogeneous in recent quarters as well, with rents in some countries falling by up to 25% year on year. At the same time, office vacancy rates have been rising steadily from around 7%

in mid-2008 to an average of 10% in the third quarter of 2009, which is likely to put further pressure on rents in the period ahead.³

INVESTMENT ACTIVITY

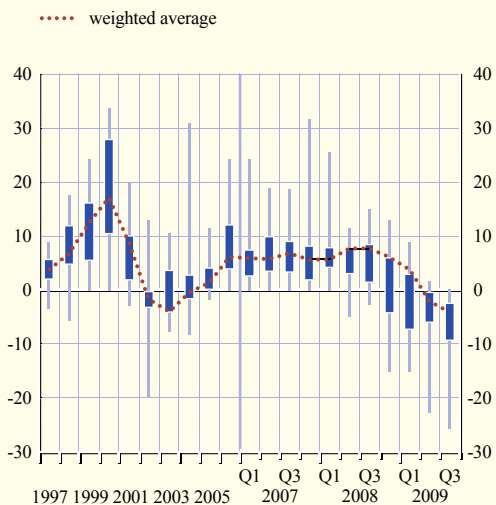
Commercial property markets in the euro area grew rapidly between 2004 and 2008 on account of the large price increases in many countries and considerable property development activity, fuelled by favourable economic conditions. This was accompanied by a significant growth in investment volume. Quarterly investment volumes grew steadily from about €10 billion in the first quarter of 2004 to a peak of €34.5 billion in the third quarter of 2007 (see Chart 10).

Leveraged investors, such as private equity funds and hedge funds, were behind much of the investment activity during this period. These investors were attracted by the relatively high returns on commercial property in an

³ See Jones Lang LaSalle, "Key market rental indicators – Q3 2009", October 2009.

Chart 9 Changes in rents for prime commercial property in euro area countries

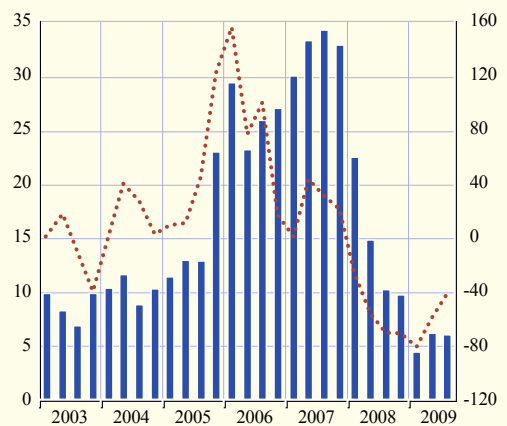
(percentage change per annum; maximum, minimum, interquartile distribution and weighted average)



Source: Jones Lang LaSalle.
Note: Data for Cyprus, Malta, Slovakia and Slovenia are not available.

Chart 10 Commercial property transaction volumes in the euro area

— billions (left-hand scale)
..... percentage change per annum (right-hand scale)



Source: DTZ Research.

environment where the search for yield had compressed returns on many other asset classes. The availability of cheap financing from banks and in capital markets further contributed to investor demand for commercial property. Demand was also strong from insurance companies and pension funds looking to make long-term investments to match their long-term liabilities.

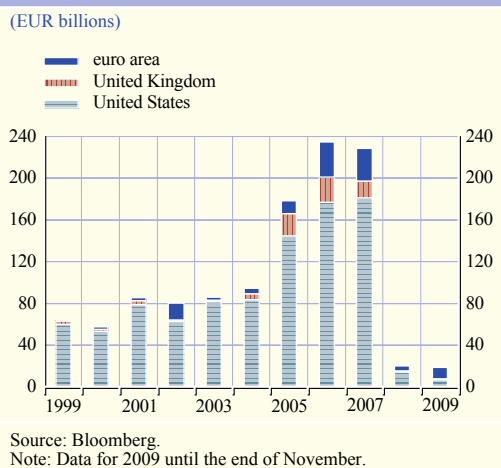
The high levels of sale and leaseback activity recorded in many countries, whereby a non-property company sells, for example, its headquarters and leases it back to free up capital, further contributed to the strong investment activity of recent years.

After the end of 2007, investment volumes fell rapidly and stood at €4.5 billion in the first quarter of 2009. This represented an 80% decrease compared with the peak in the third quarter of 2007 (see Chart 10). Volumes increased somewhat in the second and third quarters of 2009 compared with the first quarter. This was the first sign in seven quarters of investment volumes stabilising, although investment activity still remains low.

COMMERCIAL MORTGAGE-BACKED SECURITIES MARKETS

Commercial mortgage-backed securities (CMBSs) are a type of bond issued in securities markets and backed by mortgages on income-generating properties. Together with the high commercial property price inflation between 2004 and 2007 and a general appetite for structured finance products, the European CMBS market developed and grew rapidly (see Chart 11), although its size remained much smaller than many other asset-backed securities markets and the US CMBS market. Amid the turbulence in credit and commercial property markets, the issuance of CMBSs came to a near halt in Europe after the summer of 2007. This meant that it was no longer possible for banks to reduce commercial property lending exposures via CMBSs.

Chart 11 Issuance of CMBSs in the euro area, the United Kingdom and the United States

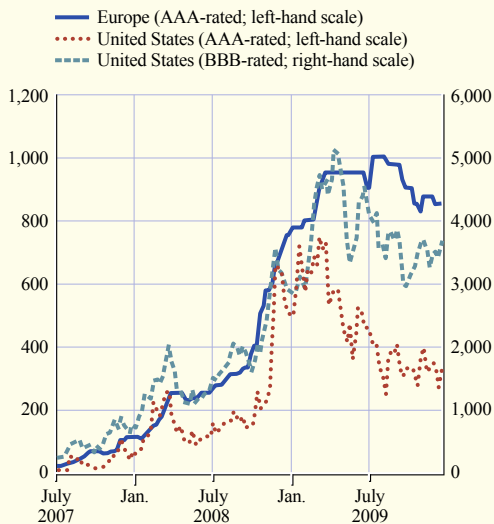


The strains in credit and commercial property markets have resulted in large-scale rating downgrades of European CMBSs by rating agencies, and many issues are currently on negative rating alert. The rating downgrades were driven, in particular, by: i) a significant increase in estimated loan-to-value ratios owing to falling property values and other types of covenant breaches; ii) an increase in refinancing risk since many CMBSs will mature in the coming two to four years; and iii) rating changes of credit-linked entities (banks, corporates and sovereigns) that had knock-on effects on the ratings of some CMBSs. The CMBS rating downgrades have in turn caused losses and collateral calls for banks, insurers and other investors in CMBS markets.

European CMBS spreads have been pricing in an increasingly pessimistic outlook for the market. Whereas spreads on many other types of credit and structured credit securities have narrowed substantially in recent months, those of European CMBSs have remained elevated (see Chart 12), largely as a result of the negative and uncertain outlook for commercial property markets in Europe. By contrast, in the United States, AAA-rated CMBS spreads have narrowed significantly since early 2009 (see Chart 12). However, it is important to bear in mind that

Chart 12 Spreads on CMBs in Europe and the United States

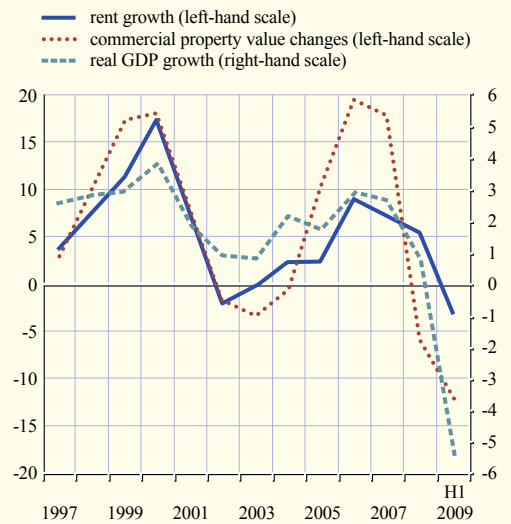
(basis points)



Source: JP Morgan Chase & Co.
 Note: A spread of 1,000 basis points means that it costs EUR/USD 1,000 to insure EUR/USD 10,000 worth of debt against default.

Chart 13 Changes in the capital value of prime commercial property in the euro area, commercial property rent growth and euro area real GDP growth

(percentage change per annum)



Sources: ECB and Jones Lang LaSalle.
 Note: Commercial property data for Cyprus, Malta, Slovakia and Slovenia are not available.

liquidity in the US market has been bolstered by the extension by the Federal Reserve System of its Term Asset-Backed Securities Loan Facility (TALF), launched in December 2008, to also include AAA-rated legacy CMBSs. Notably, spreads on lower-rated US CMBSs not eligible for TALF loans remain wide (see Chart 12).

OUTLOOK AND RISKS FOR EURO AREA COMMERCIAL PROPERTY MARKETS AND COMPANIES

Commercial property investors typically face two types of risk. First, they bear income risks if vacancy rates increase, rents decrease or prices fall. Second, they are exposed to funding risks resulting from factors affecting the availability of credit and the cost of debt, such as an increase in interest rates, the tightening of bank lending standards or a decline in demand for corporate bonds.

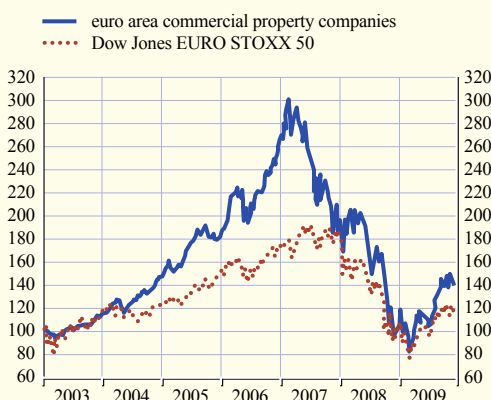
The outlook for commercial property prices and rents largely depends on the future path of economic activity in the euro area, as developments in commercial property markets follow the business cycle rather

closely (see Chart 13). In addition, expected high tenant default rates in the period ahead and the continued weakness of the euro area labour market are also likely to keep demand for rented property muted. Falling prices are mainly a concern for investors financed by loans as a large stock of commercial property loans are due to be reset in the coming years, many at prices below purchase prices. More losses are thus likely in the period ahead as a result of banks' exposure to commercial property lending and investment (see below).

As a result of the financial crisis and lacklustre developments in commercial property markets, funding costs and risks for commercial property investors are relatively high. Although commercial property investors have benefited from low interest rates, banks continue to apply more conservative lending standards – including lower loan-to-value ratios – and higher margins for commercial property loans. A decrease in the availability of financing or an increase in the cost thereof places constraints on those commercial property investors who are dependent on external funding.

Chart 14 Euro area commercial property company share prices and the Dow Jones EURO STOXX 50 index

(index: January 2003 = 100)



Source: Bloomberg.

The uncertain outlook for commercial property markets in the euro area is also visible in forward-looking market indicators. Although the share prices of companies engaged in the ownership, trading and development of income-producing real estate in the euro area have risen by some 70% since March 2009, they remain well below the levels seen in previous years (see Chart 14).

Looking further ahead, the uncertainty surrounding the outlook for commercial

Chart 15 Expected default frequencies of commercial property companies in the euro area

(percentage probability; median)



Sources: Moody's KMV and ECB calculations.

Notes: The expected default frequency provides an estimate of the probability of default in the following year. The data refer to around 200 real estate companies engaged in a broad range of real estate activities.

property companies in the euro area has resulted in historically high expected default frequencies for many companies (see Chart 15).

All in all, conditions in many euro area commercial property markets remain fragile. Looking ahead, the negative developments in euro area commercial property markets are likely to continue until economic conditions improve and investor appetite for commercial property returns.

4 EURO AREA BANKS' EXPOSURES TO COMMERCIAL PROPERTY

THE SIZE OF THE COMMERCIAL PROPERTY LENDING MARKET IN THE EURO AREA

While the risks to banks stemming from commercial property markets are increasingly understood, information about the magnitude of banks' exposures to these markets has been rather limited and fragmented across the euro area and the EU so far. In this article, the lending exposures of euro area banks relating to commercial property are estimated by using survey-based information received from national central banks and supervisory authorities, as well as information from industry sources (such as real estate adviser companies).

In 2008 the Banking Supervision Committee (BSC), which is a forum for cooperation between NCBs and supervisory authorities in the EU and the ECB, carried out a survey among EU banks on exposures related to commercial property and the management of these exposures.⁴ Data were collected from banks on a consolidated basis. As for the definition of commercial property loans used in the survey, countries (banks) were asked to apply the definition used by the IMF to compile its financial soundness indicators. According to this definition, commercial property loans comprise loans that are collateralised by commercial property, loans to construction companies and loans to companies active in the development of real

4 ECB, "Commercial property markets: financial stability risks, recent developments and EU banks' exposures", December 2008.

estate. Significant efforts were made to tailor the data collection exercise so as to make indicators for banks' commercial property exposures comparable across countries. Nevertheless, some inconsistencies may have remained, for instance owing to different loan classification practices applied by banks.

The survey results revealed that many euro area banks have substantial lending exposures related to commercial property in terms of both total assets and total loans. On average, at the end of 2007, commercial property loans accounted for 5.2% of the total assets of the euro area banks surveyed, and for 10.4% of their total loans. In absolute terms, the gross commercial property loans of euro area banks taking part in the survey amounted to €1.1 trillion in December 2007.

It is important to stress that there are large differences across the surveyed banks in terms of their commercial property lending exposures. This is evident from the wide dispersion in the commercial property loan shares of the surveyed euro area banks across different countries, which ranged from 1.8% to 36.1% and from 1.1% to 28% as a share of total loans and total assets, respectively.

Regarding the comparability of these ratios at the country level, a certain degree of caution is warranted. First, the coverage of the survey differed significantly across countries, ranging between 40% and 100% of total banking sector assets. Second, some countries only reported data on the banks that are the most active (or indeed specialised) in commercial property lending, while others provided data on the whole banking system (e.g. based on credit registers or other sources).

In addition to the BSC survey, information on banks' commercial property loans can also be drawn from the sectoral breakdown of loans to non-financial corporations, as these loans also include loans related to commercial property. Importantly, these data allow some inferences to be drawn on the development of commercial property lending over time for the whole euro

area banking sector. However, some caution is needed in interpreting the indicators based on the sectoral breakdown, as this category also includes lending related to other activities.⁵

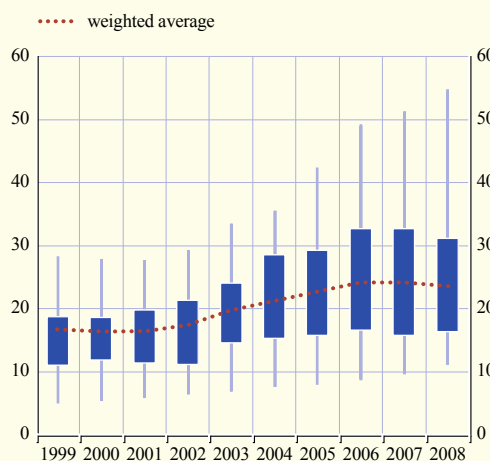
Based on this measure, in most countries, bank lending exposures to the commercial property sector increased steadily over the years leading up to the eruption of the financial turmoil. Some countries witnessed large increases in loans for commercial property (excluding lending for construction) as a share of total lending to non-financial companies (see Chart 16). Against the background of the intensification of the economic downturn and a significant deterioration in commercial property market conditions, euro area banks, on average, slightly decreased their lending exposures to the commercial property sector as a share of loans to non-financial firms in 2008.

In absolute terms, based on this measure, the gross commercial property lending of euro

⁵ Furthermore, it should be noted that these indicators were provided on a domestic consolidation basis, as opposed to the broader consolidation basis used in the above-mentioned BSC survey.

Chart 16 Country distribution of banks' commercial property loans (excluding lending for construction) in the euro area

(percentage of total lending to non-financial corporations; maximum, minimum, interquartile distribution and weighted average)



Sources: ECB, DTZ Research and ECB calculations.

area banks is estimated to have amounted to €1.1 trillion in December 2008.⁶

BREAKDOWN OF COMMERCIAL PROPERTY LENDING BY GEOGRAPHIC LOCATION AND PROPERTY TYPE

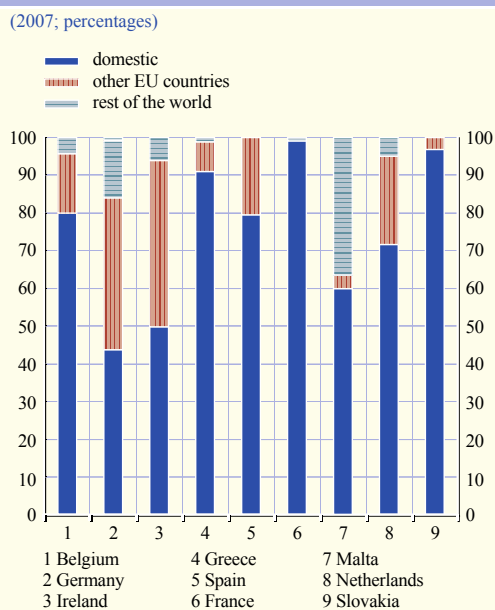
In order to assess the riskiness of commercial property lending, in addition to qualitative information on banks' risk management practices such as proper due diligence on the borrower, quantitative information on the geographical location, property type (office, retail or residential) and the purpose of the loan (development or investment) is also needed.

There is limited data available publicly regarding these breakdowns as only those lenders focusing on commercial property lending tend to provide these details in their financial disclosures. Therefore, information from the BSC survey is used. In addition to questions about the size of exposures, this survey also contained questions on the distribution of commercial property loan portfolios according to these three dimensions.

As regards the geographical breakdown, the bulk of commercial property lending is domestic. However, in some countries – in particular those in which some of the largest property lenders operate – banks have significant cross-border exposures, mainly to other EU countries (see Chart 17). Commercial property lending activity to the United States by the surveyed euro area banks appears to be modest, amounting to €45 billion, which corresponds to 5% of the total commercial property loans at the end of 2007, for those euro area banks which reported on the geographical breakdown of their exposures.⁷

Several euro area countries also provided information on the breakdown of commercial property loans by property type, such as office, retail or residential. The importance of different property sectors varies to a great extent across

Chart 17 Geographical breakdown of commercial property loans issued by the surveyed euro area banks, by country



Source: Banking Supervision Committee.
Note: For France, data are available on a domestic consolidation basis.

countries (see Chart 18). On average, banks' exposures appear to be the highest for the office sector, although it is difficult to detect common patterns across the countries that provided information on this breakdown.

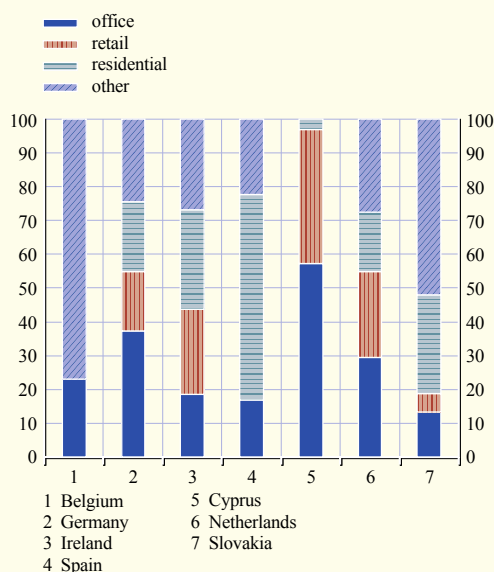
Another important aspect to be considered when assessing the riskiness of commercial property lending is the purpose of the loans, i.e. loans to developers versus loans for investment purposes. Lending to real estate developers tends to be the riskiest portion of any real estate lending, as properties are usually under construction or not yet let, and banks may face significant problems in recovering their exposure should the property developer face financial difficulties.

⁶ Note that while this figure is very similar to that obtained from the BSC survey, the figures are not fully comparable, as data collected through the two exercises differ in coverage and consolidation as well as, albeit to a limited extent, in definition.

⁷ Note that not all countries were able to provide the relevant figures.

Chart 18 Property sector breakdown of commercial property loans issued by the surveyed banks, by country

(2007; percentages)



Source: Banking Supervision Committee.
Notes: The survey covered only three categories (the retail, office and residential sectors), which do not add up to 100% of total commercial real estate loans. The residual is shown as "other" (e.g. industrial and hotels and leisure).

Since information relating to the purpose of the loans was relatively scarce in the BSC survey, data publicly available for a sub-sample of euro area banks was used to assess the relative share of loans for development and investment.⁸ On the basis of this limited information, the average share of loans to developers for this sample of banks was 21% in 2007, although this masks significant differences across institutions.

LENDING STANDARDS AND CHANGES IN RISK APPETITE SINCE THE BEGINNING OF THE FINANCIAL TURMOIL

Contrary to practices in the United Kingdom and the United States, bank lending surveys in the euro area do not cover commercial property lending. Therefore, the relevant results from surveys carried out by DTZ, a global real estate adviser, and the BSC are used to assess recent trends and expectations regarding banks' lending standards.

As the BSC survey was carried out in the second quarter of 2008, it has, to some extent, already captured the change in banks' lending behaviour in the wake of the eruption of the financial turmoil. Indeed, survey responses suggest that, since the onset of the financial market turmoil, banks' risk appetite has, in general, decreased. Several banks reported that, as from the second half of 2007, they started to tighten their credit standards, for instance by applying lower loan-to-value ratios. There were also indications of an increase in risk differentiation across markets, with lower new loan origination, stricter credit standards and higher risk premia applied to riskier regions and/or riskier activities (e.g. the share of development financing has declined). Overall, survey responses suggested that, on balance, euro area banks have already started to tighten their credit standards with respect to commercial property lending since the onset of the financial turmoil and have increasingly focused on the financing of better quality borrowers and assets.

A more recent survey, carried out by DTZ among European property lenders, covered, among other things, banks' expectations regarding lending activity and lending terms and conditions for both 2009 and 2010.⁹ Overall, these results suggest that the tightening of credit standards continued in 2009, owing to the deteriorating conditions in commercial property markets, and that banks are not likely to ease them again until after 2010.

In particular, the survey results revealed that the overwhelming majority of banks expected to tighten their lending terms and conditions in 2009, while a third of lenders expected further tightening in 2010. Following reductions in loan-to-value ratios in 2008, nearly half of the banks expected a further decrease in 2009 and most lenders expected to maintain loan-to-value ratios at these lower levels in 2010. At the same

⁸ For the exposures underlying the calculation, see JP Morgan Chase & Co., "European banks: quantifying earnings at risk from commercial real estate", 4 November 2008.
⁹ See DTZ Research, "European Lenders Survey", May 2009.

time, the vast majority of lenders expected to increase margins in 2009 and nearly 40% of banks indicated further increases in 2010.

Regarding banks' expectations for gross new lending, nearly half of the lenders expected to decrease lending in 2009 and only about 20% of banks expected an increase. For 2010, however, the net percentage of lenders expecting to increase lending turned positive. As for the outlook for the European lending market as a whole, the majority of lenders did not expect a substantial recovery until after 2010.

ASSET QUALITY

Information on the quality of commercial property loans is scarce as most banks do not disclose the breakdown of impaired loans or loan loss provisions by industry or sub-sector. The limited information that is available on asset quality regarding commercial property lending can be gathered from public disclosures by banks that specialise in such lending or for which commercial property is an important business segment, and is thus reported separately.

Most of the banks that disclose such information reported a significant increase in loan loss provisioning and/or non-performing loans in 2008 and, where data thereon were available, in the first half of 2009. For this sub-sample of banks, provisioning rates on commercial property loans increased significantly in 2008, from about 0.1-0.3% in 2007 to 0.4-2.1% in 2008. Based on disclosures for the first half of 2009, the increase in provisioning costs for commercial property loans even accelerated for a number of large commercial property lenders. Provisioning rates (on an annualised basis) for banks in this sub-sample ranged from 0.7% to 6.9% in the first six months of 2009. As a consequence of rising loan loss provisions, some banks began to report losses in the commercial property business segment in 2008 and, based on developments in the first three quarters, are likely to record losses in 2009 as well.

While the limited sample does not allow inferences to be drawn on the quality of

commercial property loan portfolios of the euro area banking sector as a whole, the wide variation of provisioning rates suggests that loss rates on commercial property loans will ultimately vary substantially across banks. The outlook for asset quality is likely to differ among banks, partly as a result of the geographical distribution of their commercial property loan portfolios. In particular, banks significantly exposed to the commercial property markets that have experienced the most significant deterioration (e.g. in Ireland, Spain, the United Kingdom and the United States) are likely to record above-average loss rates. In this respect, it should be noted that some euro area property lenders have significant foreign exposures and thus their performance does not only depend on the conditions in their domestic commercial property markets. Other important factors that could determine differences in lenders' performance in future include the share of development loans, which often carry higher risks than other types of loans, and the quality of underwriting standards.

5 CONCLUDING REMARKS

Commercial property markets are important from a financial stability point of view mainly because commercial property lending constitutes a considerable share of banks' assets. Indeed, it is estimated that loans extended for commercial property purposes account for about 10% of the total loans issued by euro area banks. It should be noted, however, that the importance of commercial property lending varies greatly across banks, and indeed banking sectors, in the euro area.

History has shown that adverse developments in commercial property markets have the potential to cause significant losses for banks and severe financial instability. This, together with the growing size of commercial property markets in the euro area in recent decades, means that the monitoring and analysis of commercial property market developments is warranted for financial stability analysis. This task is challenging, however, as the data on developments in

commercial property markets are often of poor quality and are not harmonised across countries. There is thus a need for better data on both prices and banks' exposures.

In addition, because of the significance of commercial property exposures for some banks, it is crucial that banks have sound risk management practices. For the same reason, it is important for supervisors to have adequate information on banks' exposures to commercial property markets and to monitor developments in these markets in order to be able to identify potential risks faced by banks.

Given the deterioration in most commercial property markets, several euro area banks have recorded reduced incomes, or even losses, in their commercial property business in recent quarters. Going forward, weak demand for renting commercial property and deteriorating tenant performance are likely to contribute to an increase in non-performing loans. As a consequence, banks with significant commercial property lending exposures could face the risk of elevated credit losses further into 2010, in particular if they are exposed to weaker performing property markets.