Global Property Outlook and Role of Real Estate in the European Financial Crisis

BY ROBERT PETO, MA, FRICS

I HAD THE PRIVILEGE OF SPEAKING AT THE COUNSELORS OF Real Estate® Midyear Meetings in San Diego in May this year on global real estate trends, but in truth, part of my speech was devoted to the relationship between real estate and the health, wealth and happiness of our respective peoples. My belief is that those who do not understand that real estate is one of the four factors of production (land, labour, capital and entrepreneurship) and that there is a looped connection between politics, macroeconomics, human psychology, finance and real estate, are not likely to make good decisions. Sadly, it would seem that politicians, regulators and central bankers have been ill-educated on this or have chosen to ignore the loop.

Consider the World Bank calculation that some 70 percent of global wealth is in real estate. If the dynamics of real estate prices become too volatile and out of balance in relation to affordability, then the destabilising effect on economies can be enormous. One of the major issues for the U.S. financial authorities was the failure of the Federal Reserve to believe that asset price bubbles were damaging and that they could be left to subside or crash without knock-on effects. How wrong they were as the residential bubble in the U.S. created $7 trillion of mythical value (value above long-term sustainable trends linked to affordability) which was used to enhance consumer spending. When this subsequently evaporated the consequences were horrendous.

It was William McChesney Martin Jr., one of the greatest Federal Reserve chairmen, (who was in office for 19 years from 1951 to 1970, serving five presidents from Harry Truman through to Richard Nixon), who once said that the job of central bankers is "to take away the punch bowl just as the party is getting started." In the past 15 years or so this sound advice appears to have been completely ignored. Greenspan kept interest rates too low for too long, encouraged by successive U.S. administrations not prepared to face up to the need for adjustment in the short term.

Both the Asian financial crisis of 1998 and the current global financial crisis (GFC), with their subsequent economic and political crises, were, in the final analysis, triggered by the bursting of real estate price bubbles, linked in both cases to fraudulent activities. This of itself

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would not have been catastrophic had property not been abused through unwise leadership and the application of game theory to risk management, leading to the creation of an inverse pyramid of debt and insurance products which Warren Buffet so eloquently described as "weapons of financial mass destruction."

As John Kay said in one of his *Financial Tim*es columns in the summer of 2009: "The explosion of derivative markets and the application of sophisticated mathematics to risk modelling is a tribute to how theories can readily be given practical application if the rewards are sufficiently large." He went on to say: "The risks that the financial sector has devised techniques to manage are not the everyday risks of an uncertain world—they are risks almost entirely created within the financial sector itself. The benefits to the non-financial economy are slight, if they exist at all." This is what Adair Turner, the chairman of the U.K. Financial Services Authority, had in mind in querying the social value of modern financial developments. Paul Volcker's jaundiced answer, that the only useful recent financial innovation had been the ATM, is very much to the point.

Sadly, I would also make the comment that the American approach to financial regulation which is rule/tick-box based, rather than principle based, led to some very questionable financial practices and organisational structures. These were not confined to U.S. shores as Lady Thatcher, advised by Alan Walters and Patrick Minford, her two main macroeconomic gurus, who in turn were very much influenced by the American monetarist free market economist, Milton Friedman, deregulated the City of London in 1986, thus leading to "The Big Bang" and the effective sale of the City to more powerful U.S. financial institutions from 1987 onwards.

I do not believe that any lessons have been learnt so far, as the financial institutions that were part of the problem have not been overhauled or broken up. In the U.S. it would seem that most of the poachers remain in post and some of them are actually in the administration, and have not turned into gamekeepers yet.

In the U.K., on the 16 June 2010, the Chancellor of the Exchequer announced the creation of the Independent Commission on Banking (ICB), chaired by Sir John Vickers. The Commission was asked to consider structural and related non-structural reforms to the U.K. banking sector to promote financial stability and competition and to make recommendations to the government by the end of September 2011. The Commission released its final report on 12 September. This confirmed the thrust of its interim report that suggested that the final recommendations would stop short of seeking a separation of retail (Main Street) banking from investment (casino) banking as occurred under the Glass-Steagall Act of 1933 in the U.S. Many experts believe that the repeal of this Act in November 1999 by the Gramm–Leach–Bliley Act during Clinton's presidential reign directly contributed to the severity of the GFC by allowing Wall Street investment banking firms to gamble with their depositors' money that was held in commercial banks owned or created by the investment firms.

The final ICB report recommended ring fencing of the two parts of the banking spectrum in such a way as to protect the retail bank from failure in the event that the investment banking arm makes the wrong speculative calls, without asking for their full separation. The Chancellor has indicated his support for this approach but the devil will be in the detail.

Needless to say, there has been, and continues to be, intense lobbying from the banking sector against this recommendation, and also from the Confederation of British Industry, both of which are concerned that immediate implementation would disrupt the supply of funds to industry at a critical stage in the cycle. In any event, the implementation of the recommendations is not expected to be completed until 2018, which gives plenty of time for the situation to change. Personally I believe that the outcome will be a fudge.

Having said this, it should be recognized that, in response to the financial crisis of 2008, the Basel Committee on Banking Supervision and its oversight body, the Group of Governors and Heads of Supervision, have developed a reform programme to address the lessons of the crisis, which delivers on the mandates for banking sector reforms established by the G20 at their 2009 Pittsburgh summit. Collectively, the new global standards to address both firm-specific and broader, systemic risks have been referred to as "Basel III."

As one might expect, there is a degree of cynicism as to whether enhanced capital adequacy requirements will prevent future crises. Andrew Haldane, executive director of Financial Stability at the Bank of England, has written an interesting paper based on a speech he gave at the

American Economic Association, Denver, 9 January 2011. He reminds us that:

> *these international capital standards are supported by three pillars. Pillar I defines the regulatory rules, Pillar II provides scope for supervisory discretion, while Pillar III seeks to foster market discipline through disclosure. In countering systemic shocks, three supporting pillars have understandably been felt to be better than one. But the success of international capital standards in forestalling banking distress has been mixed. Basel I regulatory rules were arbitraged due to their risk insensitivity. This gave rise to Basel II with its greater focus on risk calibration. But Basel II buckled under the weight of the recent crisis. Repairs have since been applied through Basel III. Historical experience suggests this is unlikely to be the end of road.*

He refers to an experiment carried out by the U.K. Financial Services Authority (FSA) in 2009 to establish how different banks value essentially identical exposures. For U.K. banks' wholesale credit portfolios, a hypothetical portfolio was constructed based on 64 externally rated corporate, bank and sovereign exposures. Banks were then asked to use their models to generate "probability of defaults" (PDs) and capital for this hypothetical portfolio, which could then be compared across banks. As Andrew Haldane said:

> *The range of reported capital requirements held against this common portfolio was striking. For wholesale exposures to banks, capital requirements differed by a factor of over 100. For corporate exposures, they differed by a factor of around 150. And for sovereign exposures, they differed by a factor of up to 280. Those differences could equate to a confidence interval around reported capital ratios of 2 percentage points or more.*
>
> *A final means of gauging potential model error is to consider past evidence. During the crisis, model error was largest and most egregious in the trading book. Losses were up to six times greater than pre-crisis trading book capital. And capital ratios would have needed to be up to 2.5 percentage points higher to accommodate this model risk. A fundamental review of the trading book is underway to address this problem.*
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> *This evidence only provides a glimpse at the potential model error problem viewed from three different angles. Yet it suggests that model error-based confidence intervals around reported capital ratios might run to several percentage points. For a bank, that is the difference between life and death. The shift to advanced models for calibrating economic capital has not arrested this trend. More likely, it has intensified it. The quest for precision may have come at the expense of robustness.*
>
> [Friedrich] *Hayek titled his 1974 Nobel address "The Pretence of Knowledge." In it, he highlighted the pitfalls of seeking precisely measurable answers to questions about the dynamics of complex systems. Subsequent research on complex systems has confirmed Hayek's hunch. Policy predicated on over-precision risks catastrophic error. Complexity in risk models may have perpetuated Hayek's pretence in the minds of risk managers and regulators.*

Haldane went on to suggest that market-based metrics of bank solvency could be a better predictive guide to central bankers as to financial stress. He refers to three possible alternative bank solvency ratios based on market rather than accounting measures of capital:

- *Market-based capital ratio: the ratio of a bank's market capitalisation to its total assets;*
- *Market-based leverage ratio: the ratio of a bank's market capitalisation to its total debt; and*
- *Tobin's Q: the ratio of the market value of a bank's equity to its book value.*

He comments on these as follows:

> *The first two are essentially market-based variants of regulatory capital measures, the third a well-known corporate valuation metric. How do they fare against the first principles of complex, adaptive systems?*
>
> *They clearly offer the advantage of simplicity and transparency. 200 million separate calculations would condense to a simple, single sum. The clerk would make a glorious return and displace the quant. Market-based measures could be observed and verified in real-time by regulators and market participants. That could help in enhancing both supervisory discretion and market discipline. Market-based capital ratios could support all three Pillars, helping to rebalance the Basel scales.*
>
> *Market-based solvency metrics offer two further advantages. First, they are not reliant on myriad, mis-specified models. They are largely model-free, if not error-free. They are robust to model error and ignorance. Second, history suggests that, at least in the latest crisis, they would have given far timelier signals of impending stress, and so a better guide to prompt corrective action, ahead*

of the crisis cliff-edge being reached.

Certainly, as I sit in London writing this article (in the aftermath of some of the most serious post-war rioting in the U.K.'s major cities) the collapse in many bank shares could be a harbinger of further serious bank distress around the sovereign debt crisis in Europe.

ROLE OF REAL ESTATE IN THE EUROPEAN FINANCIAL CRISIS

The bursting of the real estate bubble in Europe has had both immediate and consequential effects on the European financial crisis. The immediate effects were initially those of catalyst for the collapse in banking confidence, which led to the evaporation of interbank lending and the wholesale debt/bond markets, leading to the collapse of Lehman Brothers, and resulting in banks at the door of bankruptcy with seriously impaired real estate loan portfolios. The consequential effects are that European banks are too weakened by their real estate exposures to take any serious hits on European sovereign debt as well. I will comment on each of these effects in turn.

GFC ROUND ONE—REAL ESTATE DEBT AND THE BANKS

The collapse of real estate values in much of the western world has brought our banking system to its knees, and led to the requirement to recapitalise, and in some cases nationalise, in part or in whole, our banks. Banks were regularly lending in excess of 90 percent LTVs at the height of the market and there was a feeding frenzy by banks to lend to real estate, and to use commercial mortgage-backed securities (CMBS) conduits to lay off risk, thus allowing more balance sheet lending. This fuelled rises in values, which led to an upward spiral in prices supported by refinancing.

Europe is much more vulnerable to the real estate problem than North America where the sources of loans are more diverse. In North America 21 percent of commercial real estate debt is provided by insurance companies and other institutions and 22 percent by CMBS, with 55 percent coming from the banks. In Europe 75 percent of commercial real estate debt is provided by banks.

The deleveraging process in relation to the banks' real estate books has hardly started, with DTZ Research (DTZ Global Debt Funding Gap – May 2011) estimating that total outstanding real estate debt in Europe of just over $2 trillion has reduced by only five percent between 2009 and 2010. In addition the refinancing time bomb is increasing as banks have been, and are, extending loans where this is necessary.

Many of the loans against core prime properties have been worked out or are deemed to be sound, but this leaves banks with a substantial debt exposure to secondary real estate. The responses to DTZ Research's annual "Money into Property" survey undertaken earlier this year shows that 15 percent of lenders claimed they had already finished dealing with distressed debt secured against prime property, 65 percent were well underway and 25 percent had not yet started. Contrast this with the responses to distressed debt restructurings in non-prime markets where only five percent considered they had finished, 42 percent were well underway and 53 percent had not even started.

It would seem that the easy problems are well on the way to being solved, helped by a significant bounce back in values and transaction volumes in the prime property sector, but it is believed that more than 80 percent of commercial property bank debt is secured against non-prime assets, and it has been calculated that in Europe about €520 billion of real estate debt is maturing in the next three years. DTZ Research estimates that there is an European debt funding gap of about $118 billion. (The debt funding gap is defined as the difference between the total bank debt/loans outstanding to the real estate sector—excluding mortgage debt to the private residential sector—and the amount that would now be lent assuming loans would not be at greater than 70 percent LTV against today's market values.)

To counter this, DTZ estimates that there is about $114 billion of equity available to invest in European commercial real estate over the next three years, either by acquiring assets directly or indirectly through the purchase of loan portfolios from the banks. The problem is there is a mismatch between the type of assets and returns sought by this capital and the type of property that is likely to come to the market if additional equity is not forthcoming from the existing borrowers at the time of loan maturity.

In addition, much of this equity will need debt to achieve desired returns and this is in scarce supply as European banks suffer from write-offs, and seek to reduce their real estate exposure due to increased capital requirements flowing from Basel III, which is being introduced progressively over the next eight years to 2019.

One example of the lack of finance for new property loans is the case of Eurohypo, a subsidiary of Commerzbank. It has slashed its commercial property lending by 43.5 percent in the first half of 2011 to €1.3 billion from €2.3 billion for the same period in 2010. It has cut its loan portfolio in the six months to end June 2011 from €72 billion to €67 billion with a stated intention to further reduce this to €60 billion by the end of 2012. In the U.K. the major banks are all pursuing similar strategies.

The CMBS market is also struggling. According to Moody's the number of securitised loans in special servicing has climbed 55 percent to 104 since October 2010. The maturity profiles for the CMBS sector will lead to some challenging refinancing issues over the next five years, and there is no sign that the market for new issues will recover in any meaningful way for some years.

There is some hope that the availability of senior debt will increase from the insurance sector, encouraged by what has become known as "Solvency II." But this would have to "explode" in size if it is to fill the financing shortfall in any meaningful way.

Until this problem is resolved European banks will continue to struggle to provide sufficient loans to normal commercial businesses to allow for investment and to oil the wheels of commerce generally. This has looped negative effects for real estate as it will slow recovery in the general economy and therefore dampen, if not weaken, the occupier demand for real estate, with consequent effects on rental income security.

What is interesting is that there has not been a flood of distressed real estate coming onto the market in most of Europe as the banks are trying to take a longer-term view of managing problems over time. They are seeking partnerships with property companies and private equity funds that can inject not just asset management expertise but also capital to reposition assets or complete projects.

The worry is, however, that many European banks will struggle to withstand the double whammy of unresolved and under provisioned real estate loan issues at the same time as suffering from heavy exposure to sovereign debt risk.

GFC ROUND TWO—SOVEREIGN DEBT AND THE BANKS

My elder brother many years ago provided me with an insightful comment about humanity. He said "the corpus of knowledge is expanding exponentially but the corpus of wisdom is static." How right he was. Just consider the following exhortation:

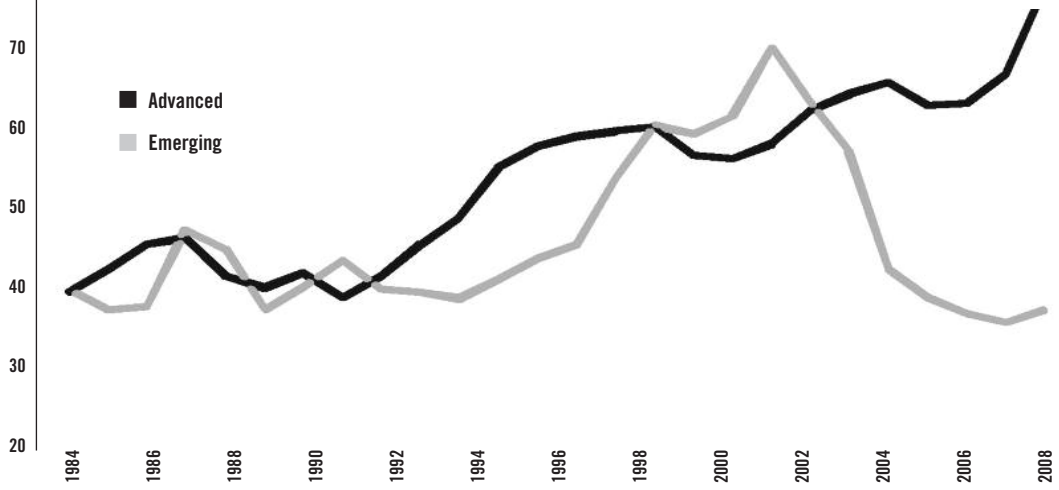
> *The budget should be balanced, the treasury should be refilled, public debt should be reduced, the arrogance of officialdom should be tempered and controlled, and the assistance to foreign lands curtailed. People must again learn to work, instead of living on public assistance.*

No, not words from a 2011 political speech, but of Cicero in relation to Rome in 55 B.C. So what have we learnt in the last 2066 years? Some might say not a great deal.

The sheer scale of indebtedness in the western world has reached alarming proportions, both in sovereign and personal sectors. In relation to sovereign debt in Figure 1 is self explanatory and gives credence to the statement that a picture is worth a thousand words.

Figure 1

Public Sector Debt as Percentage of GDP



Source: IMF

The West has permitted China to join the World Trade Organisation without insisting on a floating currency and, in the drive for short-term profits (quarterly reporting), we have allowed, if not encouraged, the transfer of considerable swathes of our manufacturing to China. In return China has indulged in the world's largest vendor financing scheme ever, by recycling her huge trade surplus into buying dollars and U.S. treasuries, thus allowing the U.S. government to run huge budget deficits. At some point the music had to stop.

Whilst reading recently a global strategy commentary by Albert Edwards of Société Générale ("Believe the Doom Merchants: Ice Age Part 3 begins") I came across a reference to a comment by the mayor of London, the colourful Boris Johnson:

> *My friends, as I have discovered myself, there are no disasters, only opportunities. And, indeed, opportunities for fresh disasters.*

Mr. Edwards commented that Ben Bernanke is living the Boris dream, but I think he could have made the same comment about the politicians on Capitol Hill, the European Central Bank and the political leaders of the EU core countries in trying to deal with the European sovereign debt crisis.

In the West we are in the perfect storm. GFC Mark 1 was caused by financial engineering and excess, partly based on real estate. In 2010 we were in the relative calm at the eye of the storm and now GFC Mark 2 has arrived, and we do not have the fiscal or monetary wiggle room to cope with this easily.

The numbers are difficult to establish but there is no doubt that if the Greek, Portuguese and Irish governments were to default on their sovereign loans it could require significant recapitalisation of many European banks to cope with the write-offs, given their exposure to these bonds. The position would be exacerbated enormously if Spain followed suit. The current bout of volatility in stock markets, especially in bank shares, reflects the uncertainty.

The situation is complicated in Europe by the political overlay of the perceived need to prevent the breakup of the Euro.

The result is that the decision currently has been taken to support the three weakest members of the euro zone, by providing additional funding through the International Monetary Fund in conjunction with the European Financial Stability Facility. This is a special purpose vehicle agreed to by the 27 member states of the EU on 9 May 2010, aiming at preserving financial stability in Europe by providing financial assistance to euro zone states in economic difficulty. In addition, the European Central Bank has been forced into buying over €20 billion of Italian and Spanish bonds to calm markets.

The view of many experienced economic commentators is that the level of funds available to support the euro zone countries is insufficient and that the true crisis is being delayed, resulting in greater difficulties when the day of final reckoning arrives. There are arguments saying those countries with debt positions that are very unlikely to be repaid should be allowed to default, and money now used to support the euro would be better spent recapitalizing the banks, allowing them to write off defaulting sovereign debt. At the present moment the politicians are pursuing the idea of enforcing closer financial and fiscal integration, which would be another step along the road to the creation of the United States of Europe. This includes the possibility of issuing euro zone bonds backed by all euro zone countries.

The uncertainties created by the financial and political turmoil and the impact of austerity measures, whether actual or psychosomatic, are now affecting business investment decisions and consumer confidence with the consequence that GDP growth in the major western economies has stalled, with the risk of a double dip recession. There is now the danger of a vicious downward spiral. This is not helped by the current ferocious debate as to whether the present problems are better dealt with by the Hayek or Keynesian economic approaches.

Whether or not this occurs, I feel confident in saying that we have at least 10 years of hard work in front of us to rebalance our economies and put our national and personal balance sheets in order.

REAL ESTATE TRENDS AND OUTLOOK

One of the remarkable features of the GFC is the extraordinarily rapid bounce back in prime commercial property values. This has been driven by a mixture of factors: uncertainty in the performance of other investment asset classes; the search for yield; and in some cases the belief that real estate is a safe haven, as even if the tenant goes bust there is always the opportunity to re-let or sell.

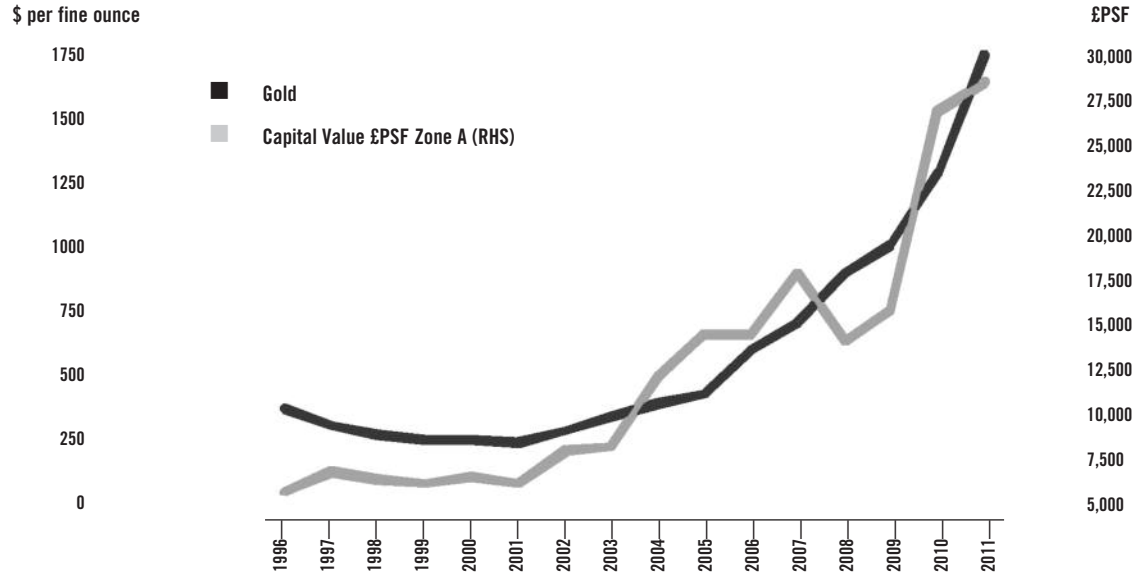
DTZ Research recently undertook an interesting but slightly unscientific exercise in comparing the value of

retail real estate in prime Bond Street in London with the value of gold over the last 15 years. The results can be seen in Figure 2. They seem to be highly correlated. This rather extreme example highlights the fact that in some special cases internationally footloose capital will look at super prime property as a gold substitute.

However one of the main driving forces in the rapid recovery in prime real estate values in the advanced countries has been the yield issue. Figure 3 plots the difference in 10-year benchmark sovereign bond yields and property yields over the last six years for various countries. The gap is significant and is encouraging institutions and sovereign wealth funds to divert significant amounts of capital into the real estate markets.

Figure 2

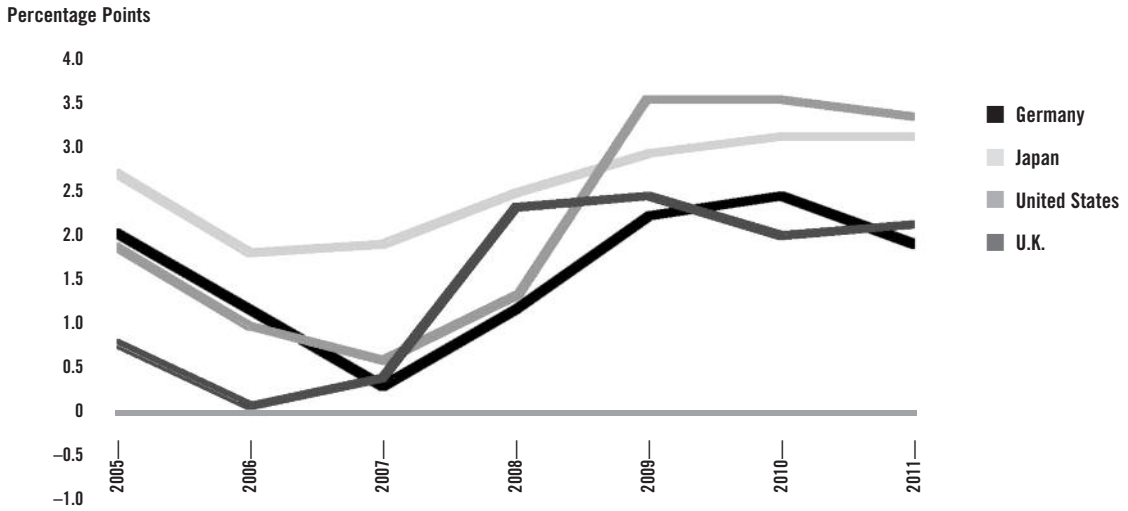
Bond Street and Gold – Capital Value Comparison



Source: DTZ Research

Figure 3

Spread Between Office Yields and 10-Year Government Bonds



Source: DTZ Research

Of course the comparison between bond yields and property yields is really relevant only to institutional type investors. Those requiring leverage will find their cost of debt linked to swap rates. These are also favourable against property yields although the growing margins demanded by banks with scarce funds available to lend to real estate are making the situation more challenging.

The bounce back in certain cases is also underpinned by actual or perceived rental growth. This has been the case in CBD London and Paris, but in some Asian countries the driving force has been the scale of general economic growth and the belief that this will drive rental growth.

Figure 4 indicates the increasing level of capital available for investment in real estate worldwide. During 2010 the amount allocated increased from $229 to $329 billion, but most of this increase is focused in Asia.

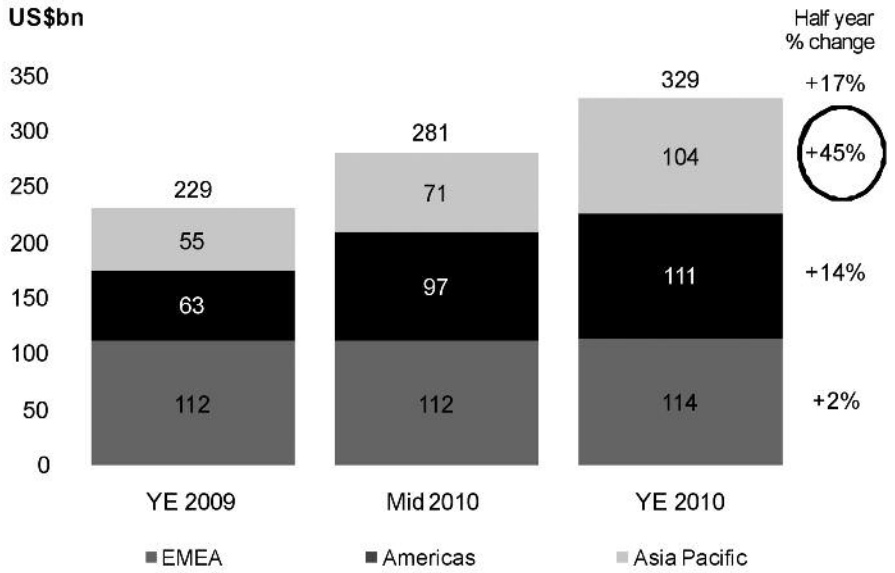
Investor debate is now beginning to focus on whether the recovery in values of good quality assets has come to an end.

FAIR VALUE?

DTZ Research has produced over the last few years a model for assessing "Fair Value" in a number of markets and sectors around the globe. This model relates anticipated income and capital receipts over a five-year hold, discounted at a risk-adjusted rate having particular regard to risk-free government bond yields in the relevant country as well as the particular characteristics of the property use type. It therefore takes into account both anticipated rental growth and yield changes and the country specific bond yield rates to produce an index of attractiveness. Any reading above 50 would indicate that current pricing is below the risk-adjusted required rate of return and vice versa.

Figure 4

Available Capital By Region 2011



Source: DTZ Research – Great Wall of Money 2011

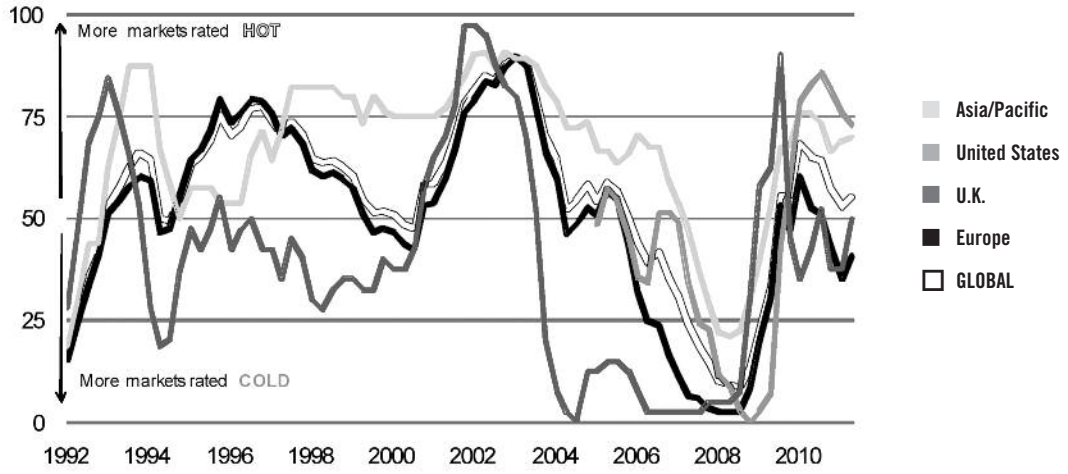
In Europe the amount of capital available has remained relatively stable and the amount of investment transactions has risen from a low of €10 billion in Q1 2009 to between €20 billion and €25 billion per quarter in the first half of 2011. One of the constraining factors has been the availability of the right product, largely in the prime sector. Existing owners are happy to keep their investments and there has not been a flood of good quality assets coming to the market as a result of debt distress.

In Figure 5 DTZ has plotted the Fair Value Index score for the major global regional markets. With the exception of the U.S., the model runs from 1992 through the present time. It is interesting to note that the pricing of U.K. commercial real estate became expensive in relation to estimates of Fair Value as far back as 2004.

The graph clearly indicates the bounce back in 2009/10 for all regions of the world, largely as a result of significant reductions in interest rates. The speed of this recovery and

Figure 5

Fair Value Index Score



Source: DTZ Research

the momentum that it built up led to an overswing, and it will be noted that, in the U.K. at least, real estate could have been deemed to have been at about or more than Fair Value in the last 18 months. This is reflected in the Investment Property Databank statistics for U.K. institutional commercial real estate where capital values have virtually now stagnated.

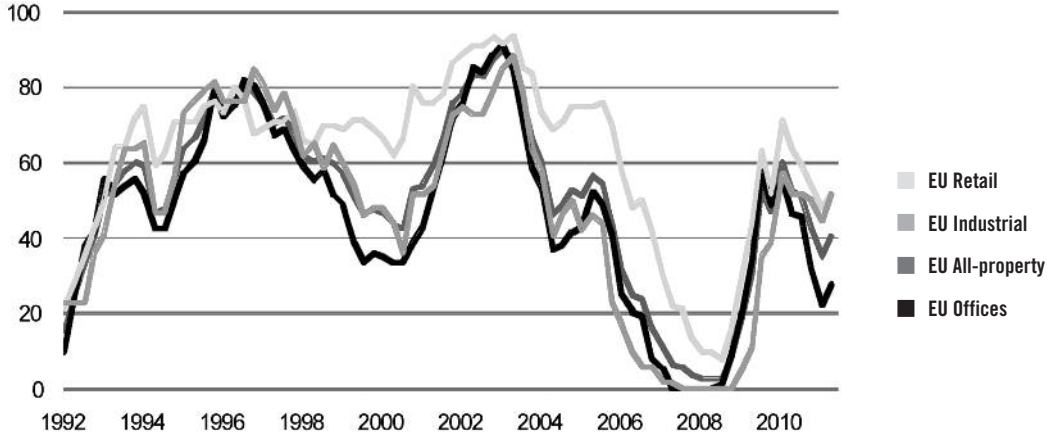
At a general level the same can be said of continental Europe.

In Figure 6, DTZ has analysed the use sectors in Europe which indicates that the office sector is the most vulnerable to potential value correction if a rational viewpoint is taken.

It is important to remind readers that these Fair Value graphs relate specifically to the prime end of the market. The secondary end continues to suffer and may well be seeing further reductions in values for two reasons. One cause is occupational markets' weakness outside the core retail and office locations and rental values' being static at best, and falling in many cases. The second cause is the absence of debt funding for this type of property to go with rising bank margins where debt is available.

Figure 6

Fair Value Index Score



Source: DTZ Research

It is also interesting to note that at the peak of the market in 2007, nearly 70 percent of all commercial property transactions in Europe involved foreign capital. This has now reversed and, whilst there is still global capital available, most of the transactions are domestic. This trend towards domestic investment is being exacerbated by the problems of currency risk given the uncertain future of the euro.

The outlook for commercial real estate in Europe is one of considerable uncertainty with weak occupational demand compounded by political and economic dysfunction. The political and financial authorities are moving reluctantly to the conclusion that there will have to be a very significant haircut on sovereign debt to Greece and probably other European countries and that therefore many European banks will need to be significantly recapitalised to withstand the writedowns. In some cases this will mean nationalisation as the private sector will not have the means or the inclination to find the €500 billion which is probably necessary.

If this is not done and done rapidly, we are all in for a very bumpy ride, which will see a significant shrinkage in debt availability for normal banking business, which is to oil the wheels of commerce. The consequences for property would be a double whammy as tenant stress will increase and debt funding will probably dry up all together.

Even if sanity prevails and there is a wholesale switch away from propping up delinquent countries to propping up the banks through recapitalisation, the best one can hope for is that prime properties are likely to hold value if bond rates remain low (a view which I would support), but secondary property in many locations is likely to see further falls in value to compensate for tenant and income risk and lack of debt financing. The one hope for the future is that, at the prime end of the market, the near absence of new development will in due course lead to a spike in rents as grade A space is slowly taken up.

I wish I had a clearer crystal ball. ■

Editor's Note: *The views expressed in this article belong to Robert Peto and do not reflect the collective house view of either the RICS or DTZ.*