

Box 11

FINANCIAL STABILITY IMPLICATIONS OF THE DRYING-UP OF SECURITISED COMMERCIAL MORTGAGE MARKETS

Amid the turbulence in credit markets, and in particular structured credit markets, after the summer of 2007 the issuance of commercial mortgage-backed securities (CMBS) came to a halt in Europe, eventually resuming at more modest issuance volumes. With lowered investor appetite for these securities, opportunities for banks to spread commercial property loan exposures were reduced. This, in turn, reduced their willingness to lend for commercial property development

and ownership. In addition, it led to revenue decline and exposures to “hung loans” for investment banks that originated commercial property loans with the aim of distributing them as structured credit products. These negative developments came at a time when commercial property markets in the euro area – at least in some countries – started to show signs of deterioration (see Section 2.3). Thus, the structured commercial mortgage market and the direct commercial property ownership and development market have the potential to negatively affect each other. This box provides a brief overview of the CMBS market in Europe and it identifies the main risk propagation channels from this market from a euro area financial stability viewpoint.¹

Banks’ loans for development and ownership of commercial property account for around 8% of total bank lending and around 27% of total lending to non-financial corporations in the euro area, although these shares vary considerably across countries. High construction activity and large volumes of direct investment in commercial property witnessed in recent years in the euro area, which were, in large parts, debt-financed, created a need for banks to spread some of the related credit risk via debt securities. In 2007 roughly 10% of all bank loans in the euro area extended for commercial property purposes were securitised.² This credit risk transfer was achieved mainly by means of the issuance of CMBSs, which are a type of bond issued in securities markets and backed by mortgages on income-generating properties.³ Such securities were first introduced in the United States in the early 1990s, when they were used to clean up bad loans.

Issuance of CMBSs in Europe has grown rapidly in recent years (see Chart A), and the issued amount totalled €48 billion in 2007.⁴ The United Kingdom is the largest market for CMBSs in Europe, but activity in euro area countries was increasing before the recent turmoil erupted. In Germany, for example, the total value of CMBS issuance was about 400% higher in 2006 than in 2005, mainly because of the sale of large housing portfolios.⁵ However, in the latter part of 2007, due to lowered demand for structured credit products coupled with an uncertain outlook for commercial property markets, issuance of CMBSs came to a halt. Issuance activity in the euro area during the last quarter of 2007 dropped to €2 billion from €6.2 billion one year earlier. Also, expectations among some market participants are that issuance volumes in 2008 will be sharply down on those of 2007 both in the United States and in Europe. Estimates show issuance falling by between 36% and 89% to levels last seen in the mid-1990s (see Chart A).⁶ Indeed, European CMBS issuance activity during the first quarter of 2008 was approximately 7% of the level in the same quarter the previous year.⁷ Reduced investor demand for these products was also shown in CMBS spreads, which rose sharply after the summer of 2007, and banks’ costs for selling on commercial mortgage exposures have thus increased substantially (see Chart B).

1 Lately, commercial mortgage CDOs have joined CMBS transactions as an additional vehicle for the financing of commercial real estate. These can be backed either by rated collateral, such as CMBSs, or by commercial real estate loans.

2 Estimation based on various national sources and ECB lending data for monetary financial institutions (MFIs).

3 See also ECB (2007), “Commercial property investment and financial stability”, *Financial Stability Review*, December. Among the asset types, mortgages on office and retail properties are the largest underlying assets.

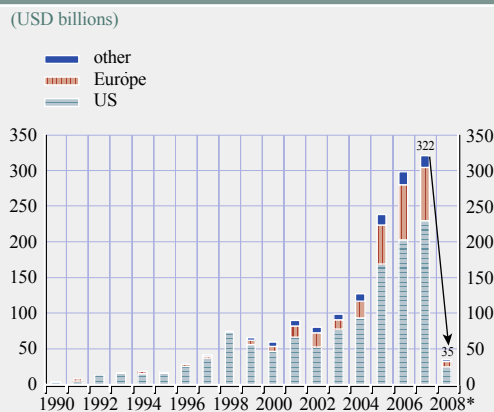
4 See European Securitisation Forum (2008), “ESF Securitisation 2008 Market Outlook”.

5 See Moody’s (2007), “2006 Review and 2007 Outlook: EMEA CMBS: Another record year with tremendous growth in the German CMBS and multifamily market”, January.

6 See European Securitisation Forum (2008), “ESF Securitisation 2008 Market Outlook” and Morgan Stanley (2007), “CRE Differentiated: Avoid Mark to Market Risk & CMBS Flow: But Rental Cash Flows”, December.

7 See JP Morgan Chase & Co (2008), “European ABS Weekly”, 31 March and 21 April.

Chart A Commercial mortgage-backed securities issuance and forecast



Source: Morgan Stanley.
Note: Data for 2008 are forecasts (marked with *).

Chart B Commercial mortgage-backed securities spreads in Europe



Source: JPMorgan Chase & Co.

The main investors in structured commercial mortgage products are specialised money managers, banks and SIVs. These investors were attracted by, among other things, attractive returns, the high ratings of the structured products and diversification benefits, as CMBSs typically have exposure to a number of loans extended for a wide variety of property types in different geographical regions.

Four main risk propagation channels from lower CMBS issuance can be identified: i) credit risk exposures of banks to commercial property loans may increase and higher impairment charges might be needed to cover bad loans where commercial property is used as collateral; ii) banks and other investors holding CMBSs might face losses due to falling values of structured credit products referencing commercial property loans to the extent that they have invested in such products; iii) investment banks that generate fee income by arranging CMBSs are facing lower revenues and some banks could face further markdowns (due to wider spreads) on collateral originated for securitisation that has stayed on the banks' balance sheets (i.e. under the buy-and-distribute business model); and iv) commercial property companies might face problems in obtaining bank finance at a time when banks are tightening lending standards, and increased costs of lending could put pressure on the income of commercial property owners. This could, in turn, negatively affect commercial property prices.

All in all, in recent years CMBSs have become popular among banks seeking to transfer credit risks stemming from commercial mortgage loan portfolios. Such credit risk reduction activities on the part of banks are, in general, positive from a financial system stability perspective, as they can reduce banks' exposure to credit events in commercial property markets. However, as has been seen during the recent drying-up of these markets, banks are vulnerable to a reduction in investor demand for these products. Looking ahead, market participants are of the view that the drying-up of the CMBS market is a cyclical pause rather than an end, and that issuance going forward will be characterised by simpler and more conservative collateral structures. The prospect of a recovery in CMBS issuance activity in the future is also supported by the fact that, although commercial property markets in some euro area countries are showing signs of

deterioration, delinquency and default rates on commercial property loans have remained low and are expected to rise only modestly going forward. This viewpoint is supported by low downgrade pressure from the rating agencies.