Market Report no. 16 - synopsis

Real estate banks in focus? The contribution of real estate financing to sustainable growth

Sustainable economic growth is founded in part on solid growth in the real estate sector and its financing

The volume of commercial real estate finding in Germany reached some 250 billion euros in 2009 - about one fifth of the total lending of all banking groups to domestic businesses and the self-employed.
Without commercial real estate there is no commercial activity, neither in industry nor in the service sector. The structure, growth and maturity of an economy are reflected in its real estate sector.
The real estate sector is one of the key industries in all developed economies. In Germany some 700,000 enterprises are actively involved in the various parts of the real estate sector. That represents about 22 per cent of all companies in Germany.
The real estate sector is dominated by SMEs, the backbone of the German economy. The real estate sector is the real economy, and so constitutes one of the growth sources of an economy.

Real estate financing is a special kind of project financing with specific know-how. Banks must be able to meet this particular requirement

The requirements of the real estate sector on financiers are many and varied. This requires specialist knowledge and experience. It also means that real estate banks must focus on the individual customer, not the financing. The standardisation of financing deals is frequently not appropriate to the requirements of customers. Those most able to meet the financing needs of the real estate sector are specialist banks with profound real estate expertise and a business model that combines the virtues of traditional credit financing with capital market experience and a ‘relationship orientation’.

Regulation and lasting economic growth could come into conflict

More regulation does not automatically mean better regulation. The new regulatory conditions must do the splits between the necessary stability of the financial sector and the smooth financing of projects in the real economy. Basel III and all other changes in supervisory parameters should not lose sight of the principle of treating equal things equally and unequal things unequally. This demands a particular focus on all regulations affecting the financing of real estate. The danger of a credit crunch if insufficient prudence is exercised in the revision of regulations cannot be rejected out of hand. Nor can the possibility that real estate companies will, if bank financing is put under prohibitive pressure, opt for alternative financing options, with all the imponderables that this would entail.

The binding leverage ratio: pfandbrief banks at risk from a key indicator

The proposed leverage ratio is intended to limit the balance sheet total to 33 times the new Tier 1 capital. This would particularly affect pfandbrief banks. Because of the low risk weightings of their assets, banks that have a significant volume of mortgage-backed lending business have a relatively low capital base. They would thus be particularly impacted by a leverage ratio as a binding indicator. In some circumstances they would be compelled to scale back their business further or build up more additional equity. Not only is this counterproductive, it also systematically disadvantages in particular the business models of the pfandbrief banks and is therefore objectionable. After all, these banks have a relatively low risk profile precisely because mortgage-backed credit is attributed comparatively low risk weightings.

Real estate financing needs the capital market

A functioning capital market is a key prerequisite for the further development of real estate financing. It is also a desirable aim to restore confidence in the securitisation markets, but securitisation will be structured differently in the future.

The market needs the certainty that the relationship between the underlying property and the capital market instrument will not be lost through the capital market.

As real estate financing is a combination of collateralised funding, non-collateralised funding and equity, banks should consider the future funding mix.

It is possible for collateralised funding to continue to be provided through pfandbriefs, while previously non-collateralised funding must be obtained in part through the junior ranking funding segment. A durably collateralised funding instrument complementing the pfandbrief, along the lines of an ABS product, would be conceivable here. It would be important that not every bank created its own product, but that instead a standardised framework was bindingly laid down through voluntary agreement, as with the jumbo pfandbrief. Real estate and pfandbrief banks have the know-how and the strong associative structure needed to develop this product.

Liquidity has become a critical competitive factor. The real estate banks were the first to learn this lesson

Unlike universal banks, real estate banks have always regarded liquidity and liquidity management as a major competitive factor. As wholesale banks, they differentiated from an early stage between the supervisory management and the operative management of liquidity. The institutions that tend to be well-equipped to handle future challenges are those with a buy-and-manage approach, in-house risk verification, clearly defined risk viability concepts and the means to balance out economic and real estate cycles by diversification at country and property level. It is also important that confidence in the property markets and in real estate financing grows faster if liquidity is to flow across stable markets in a continuous and calculable way.

Pfandbrief ratings – not absolutely essential, but probably unavoidable

Experience has shown that rating methods deliver no absolute truths because they work on the basis of some assumptions. The basic intention, which is to overcome the asymmetric dissemination of information between issuer and investor by means of an external rating, is fundamentally good. For the German pfandbrief, however, this task is best performed by the corresponding transparency legislation. In this case an external rating would not therefore be absolutely essential for the pfandbrief. As large institutional investors, even issuing banks, see a rating as reducing complexity, however, this instrument remains an option for the financial markets.