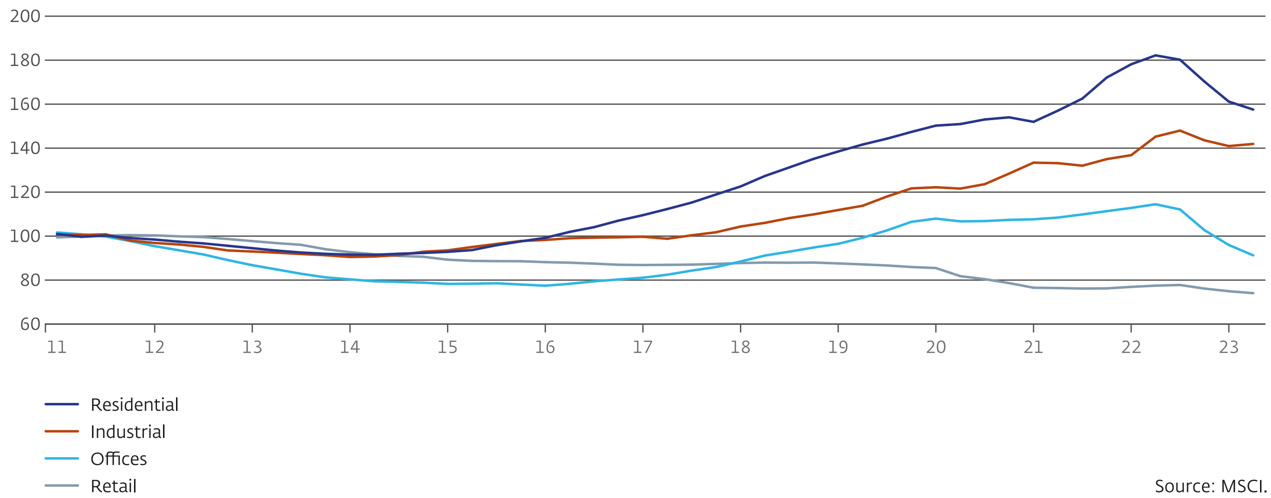
Commercial real estate risks

The Dutch commercial real estate market[3] is currently under pressure. After almost a decade of stable growth, valuations in the Dutch commercial real estate market have fallen by 13% in the past year. This fall is evident in all segments of commercial real estate, from retail premises, residential property and industrial premises to office space (see Figure 13). Furthermore, in a survey of Dutch institutional real estate investors, 90% of respondents said the market was declining, while half described current real estate valuations as relatively high. The price falls in the Dutch commercial real estate market are not isolated. Transaction prices are also falling in many other European countries (including Belgium, Germany and Sweden).

Dutch financial institutions have a substantial exposure to commercial real estate. Banks, insurers and pension funds collectively have around €360 billion invested in commercial real estate, both in and outside the Netherlands. In the case of banks, commercial real estate loans make up 7% of the balance sheet (compared to the housing market exposure that accounts for 28% of the balance sheet). Real estate loans are loans backed by property generating rental income and are largely provided by

Figure 13 Commercial real estate valuations are declining in all segments

Index, 2011=100



Source: MSCI.

3 The real estate market can broadly be divided into the commercial real estate market and the housing market. Commercial real estate consists of property owned by businesses and can be divided into five segments: residential, retail, office space, industrial premises and other real estate (including hotels). The residential segment comprises homes let by businesses and homes under construction. By contrast, the housing market includes properties owned by private individuals, such as owner-occupied homes, second homes and rental homes owned by private landlords (buy-to-let homes).

large Dutch banks. In the case of pension funds and insurers, investments in commercial real estate account for 7% and 8% of the balance sheet respectively (compared to housing market exposures of 7% and 13% respectively). These investments include holdings in Dutch and foreign real estate investment funds (referred to below as real estate funds). In terms of location, around one-third of the commercial real estate exposures of banks, pension funds and insurers are outside the Netherlands (DNB, 2022). We are unaware of the location of some of the real estate owing to data deficiencies.

Dutch real estate funds, in which pension funds in particular invest, have quadrupled in size over the past 15 years. The combined size of Dutch real estate funds in 2023 was €136 billion, equivalent to 16% of the total assets of Dutch investment funds. In recent years – partly due to the search for yield among institutional investors in the low interest rate environment – real estate funds have quadrupled in size. Pension funds, for example, hold 78% of the net asset value of Dutch real estate funds. The direct holdings of these real estate funds consist mainly of residential properties. Over one-third of the investments are in real estate outside Europe.

This section surveys the risks of the commercial real estate market for Dutch financial institutions. Due to the negative market developments, this section focuses on developments in the Dutch commercial real estate market and the associated risks for different types of Dutch financial institutions. It devotes particular attention to risks in Dutch real estate funds with regard to liquidity mismatches and the use of leverage.

Cyclical and structural changes lead to falling prices

The recent price falls in the Dutch commercial real estate market have been driven in part by higher interest rates and increased construction costs. The main (cyclical) change for real estate loans is the rise in interest rates due to the tightening of monetary policy. The average interest rate on new real estate loans in the second quarter of 2023 was around 4.7%, almost a doubling compared to three years earlier. Since commercial real estate is generally financed by debt, interest expenses make up an important part of the financing costs. High inflation also feeds through into real estate construction costs. As a result of more expensive construction materials and bottlenecks in the supply chain, construction costs have risen by 12.5% in the past 18 months. The combination of higher financing costs and construction costs leads to lower expected returns on commercial real estate, less investment and lower demand for credit. At the same time, the falling real estate valuations automatically mean that less credit can be granted under the same conditions. Lenders may also tighten their conditions for new loans as a result of the deteriorating economic outlook. For example, the volume of new real estate loans from Dutch banks in the second quarter of 2023 decreased by 16% compared to a year earlier. Tighter lending conditions for new real estate loans may further exacerbate the downward price pressure in the real estate market.

Structural changes are also putting pressure on the commercial real estate market. Societal changes, such as the popularity of e-commerce and the increase in remote working, lead to lower demand for commercial real estate. Fewer retailers need physical premises, for example, while demand from employers for office space falls. This has a negative impact on the retail and office segments of the commercial real estate market. Nevertheless, in the case of retail premises the vacancy level in mid-2022 fell back again to the 2019 level (CBS). The government has also announced legislation to tighten the regulation of residential rental properties in the mid-segment in order to improve the affordability and accessibility of the housing market. In addition, the transfer tax on rental homes has been raised. However, these structural changes also reduce future returns on commercial real estate and thus slow down investments in commercial real estate. Investments in Dutch commercial real estate fell by around 60% in the first half of 2023 compared to a year earlier (CBRE, 2023). This fall in investment is evident in all segments of the commercial real estate market.

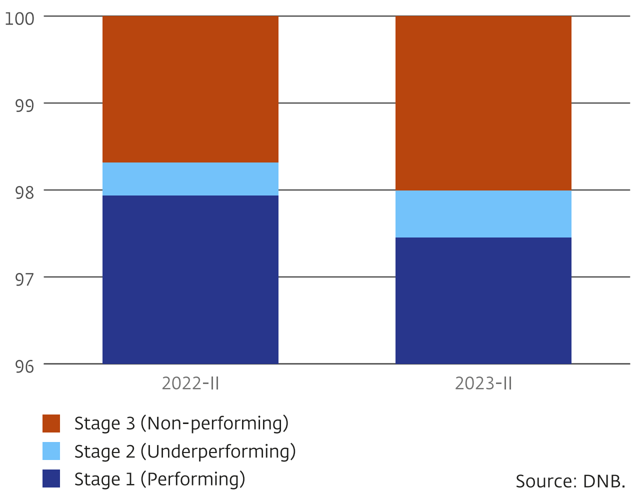
Risks are growing, but the effect on the financial sector remains limited

The higher financing costs increase the probability of default. Loans for commercial real estate are mainly repaid with rental income. This rental income generally changes more slowly than the financing conditions, so in the current environment of rapid rate rises there is a greater probability of default. This is evident in the proportion of non-performing bank loans, which have ▶

increased slightly by 0.4 percentage points in the past year. Higher interest rates appear to be a factor in this rise. Banks are seeing rises in the proportion of loans in arrears (stage 2) and non-performing loans (stage 3) among real estate loans where the interest rate has recently been reviewed (Figure 14). In addition to higher financing costs, lower rental income – for example as a result of higher vacancies due to higher corporate bankruptcies

Figure 14 Interest rate changes causes underperformi and non-performing loans at banks

Percentage of loan portfolio with interest rate changes between the second quarter of 2022 and the second quarter of 2023



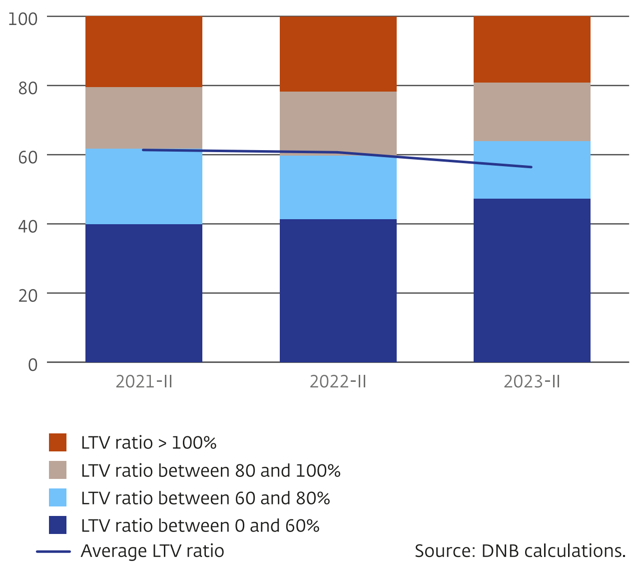
Source: DNB.

– may also increase the probability of default. This does not appear to be happening at present, as the level of vacancies in the Netherlands remains low.

Dutch banks currently show no visible signs of credit risks materialising in commercial real estate, but this situation may change. In the second quarter of 2023, the proportion of non-performing real estate loans at Dutch banks was 3.3%, well below the average of recent years (i.e. average of 5.5% between 2016 and 2022). This indicates that banks are not yet seeing any materialisation of credit risks due to real estate loans. Looking forward, it is important to note that a further fall in real estate prices may lead to an increase in non-performing bank loans. The relationship between the loan and the value of the collateral plays an important role in this risk assessment. The average loan-to-value ratio of Dutch real estate loans has fallen to below 60% in recent years (see Figure 15). The recovery rate on foreclosed commercial real estate in the Netherlands has historically been above 70%. Since the recovery rate is higher than the average loan-to-value ratio, banks are likely to be able to absorb the potential losses in the event of default on the average commercial real estate loan by selling the collateral. This is not the case with all loans, however. Around 20% of Dutch real estate loans have collateral worth less than the loan, which means that the relevant bank would face loan losses in the event of default. This portion of loans in which the collateral does not cover the losses would rise in the event of a further fall in real estate prices.

Figure 15 Average LTV ratio of loans secured by commercial real estate has edged down

Percentages



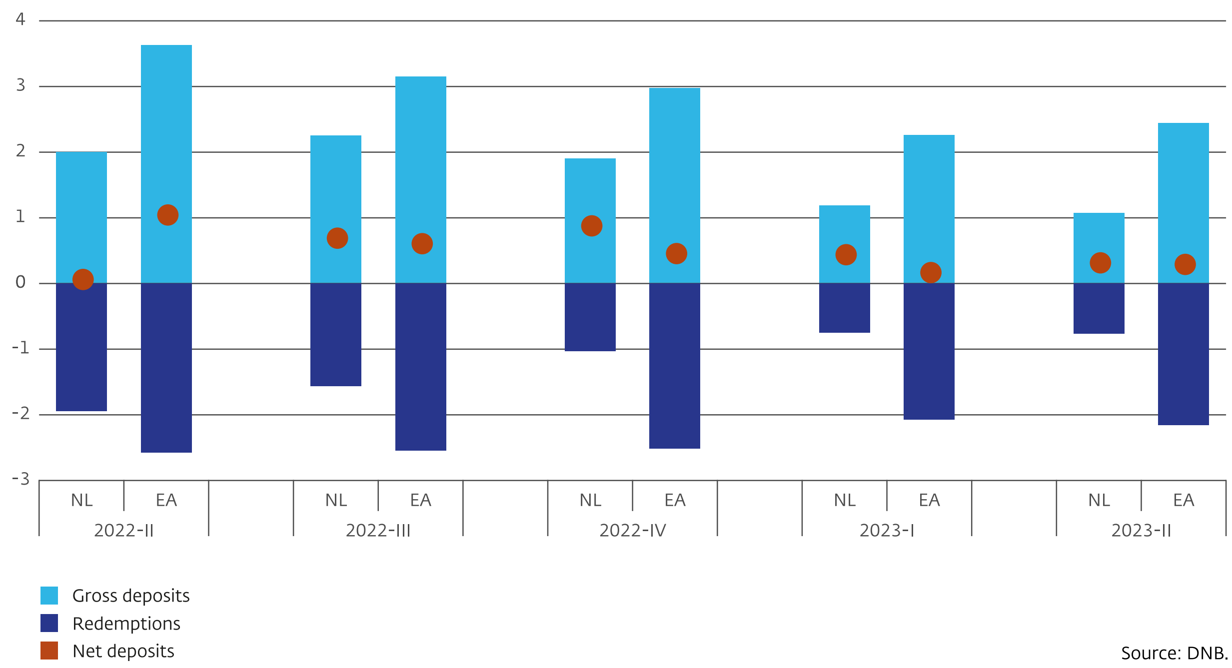
Source: DNB calculations.

Insurers and pension funds are also exposed to losses due to revaluations of commercial real estate. Price corrections in real estate markets have a direct impact on the balance sheets of insurers and pension funds, since these are based on market value. Although the losses from direct real estate exposures have so far remained limited, insurers and pension funds face falls in the value of listed real estate. Pension funds, for example, saw the value of their entire listed real estate portfolio fall by €15 billion in 2022, representing a loss of around 2.5% of the total investment portfolio (although this decline has been partly offset by currency effects). The losses due to revaluations of commercial real estate can lead to vulnerabilities in real estate funds.

Vulnerabilities of Dutch real estate funds are smaller than expected

Dutch real estate funds are generally open-ended, making them vulnerable to a liquidity mismatch. A liquidity mismatch arises when investors are able to retrieve their money from an investment fund more frequently and faster than the fund manager is able to sell the (relatively illiquid) investments in the fund. This liquidity mismatch is only a factor in open-ended investment funds, because investors can retrieve their money at any time (or at a fixed frequency). This makes an open-ended real estate fund vulnerable to a liquidity mismatch, because the fund's investments comprise real estate that is by its nature illiquid. Moreover, this may contribute to a downward spiral in the real estate market. The forced sale of real estate from the portfolio to achieve liquidity may lead to further falls in value and new redemption requests in other real estate funds.

Figure 16 Redemption requests at Dutch and European real estate funds are limited
Percentages



Source: DNB.

In the case of Dutch real estate funds, the liquidity mismatch appears to be limited because the redemption conditions for investors are closely geared to the liquidity of the investments. Dutch real estate funds manage the majority of investments through open-ended funds.[4] Despite the open-ended structure, a majority of the funds (in terms of total assets) only allow investors to request a redemption once a year. This annual redemption frequency is appropriate for the limited liquidity of real estate investments. Furthermore, the largest investors in Dutch real

4 The analyses in this section are based on Dutch real estate funds falling under the scope of the AIFM Directive.

estate funds, namely pension funds and insurers, generally have a long investment horizon, which reduces the risk of large-scale redemption requests.

This limited liquidity mismatch may explain the sustained positive inflow into Dutch real estate funds. The returns on Dutch real estate funds have deteriorated markedly since the second quarter of 2022. Real estate funds have posted a series of negative returns in the past three quarters. At the same time, the inflow of new money into Dutch and European funds exceeded investors' redemption requests during this period (see Figure 16). This suggests that funds have only had to sell a limited amount of real estate in order to meet investors' requests, although a caveat should be entered here. Due to the low redemption frequency in many Dutch real estate funds, they may face more redemption requests in the near future.
Furthermore, the use of excessive leverage is concentrated in a small number of Dutch real estate funds. Leverage is where a real estate fund uses loans and derivatives to increase its exposure to real estate. This may increase the fund's expected returns, but also makes it more sensitive to price movements in the real estate market. This increases the risk that a fund manager will be required to sell real estate assets in the event of falling real estate prices. The use of excessive leverage may therefore increase the vulnerabilities resulting from a liquidity mismatch. Leverage greater than 300% is generally deemed to be excessive, as it would mean that more than two-thirds of the assets are financed by debt. A closer examination shows that at the end of 2022 only 6% of the total assets of Dutch real estate funds were managed through funds with excessive leverage. These funds with excessive leverage also have a closed structure, so an investor can only retrieve the investment at the end of the term and there is no liquidity mismatch. In addition, around 90% of the total assets are managed by Dutch real estate funds with leverage of less than 150%. Due to the limited size of funds with excessive leverage and their closed structure, there is currently only a small risk of these funds causing a negative spiral in the Dutch real estate market.

Policy instruments are not yet needed, but vigilance is called for

Due to the negative developments in the commercial real estate market, Dutch banks should remain vigilant against an increase in concomitant credit risks. The outlook for the commercial real estate market remains challenging, if only because financial conditions are expected to remain tight for an extended period or tighten further. Losses may consequently increase and real estate valuations may fall further. Banks must therefore monitor developments in the commercial real estate market closely and be alert to any increase in credit risks. We will also continue to closely monitor the market developments and risks to banks and other financial institutions in the period ahead. Recently, the FSC discussed commercial real estate risks, noting the need to remain alert to risks, because shocks have a delayed impact and data limitations impede adequate monitoring. Existing data sources provide an incomplete picture of the financing flows and the figures are only released after a time lag.

We currently see no grounds to deploy macroprudential policy instruments for risks in Dutch real estate investment funds. The AIFM Directive enables macroprudential authorities to set limits on the use of leverage by investment funds. We currently see no grounds to deploy this instrument, because the above analysis shows that the risks to Dutch real estate funds as a result of excessive leverage are limited at present. We currently have no macroprudential instruments to address liquidity mismatches, but we endorse the recommendations of the Financial Stability Board and the European Systemic Risk Board to develop such instruments. The above analysis shows that the risks to Dutch real estate funds as a result of liquidity mismatches are limited at present. The low redemption frequency in many Dutch real estate funds nevertheless poses a risk that they will face more redemption requests in the near future. Real estate funds must therefore be alert to such developments. ■