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Weekly Credit Brief Mar 28 - Apr 03 2023

Banking crisis exacerbates the credit risk outlook of core Europe's real estate sector

by NUS-CRI Market Monitoring Team

- **NUS-CRI Forward PD of the core European real estate companies suggests credit outlook may worsen close to the BBB- upper bound, as the macroeconomic and banking uncertainty spike**
- **Stress tests indicate that an uptick in the EU banking CCI could lead to a rise by close to 10bps over the next two years in the real estate sector's Agg PD, with residential owners and developers likely to be more susceptible to worsening credit conditions compared to their commercial counterparts**

The ongoing banking turmoil, which has wreaked havoc on major global markets across Europe, has impacted funding channels, not only across the financial sector but also across the non-financial sectors. The real estate sector domiciled in core European countries[1], which has been combating rising interest rates and falling property prices, is now also dealing with the fresh blow of the banking crisis that threatens to impact their liquidity, debt-servicing, and project financing capabilities. As seen in Figure 1a, the NUS-CRI aggregate (median) 1-year Probability of Default (Agg PD) for the core-EU domiciled real estate sector has been increasing steadily since 2022 due to inflation pressures and the resultant rate hike cycle by the ECB shrinking the size of their balance sheet. The current Agg PD is above the BBB+ upper bound when referenced to PDiR2.0 bounds, surpassing the credit risk faced by the sector during the initial onset of the COVID-19 pandemic. The NUS-CRI aggregate (median) Forward 1-year PD (Forward PD[2]) also signals further woes for the sector, with the aggregate credit outlook closing in on the non-investment grade lower bound in the next twelve months. As the banking crisis lingers and fears of a prolonged recession grip the markets, the real estate sector in core European countries likely continue to operate in an unfavorable financing environment that could potentially lead to a widespread liquidity crunch.

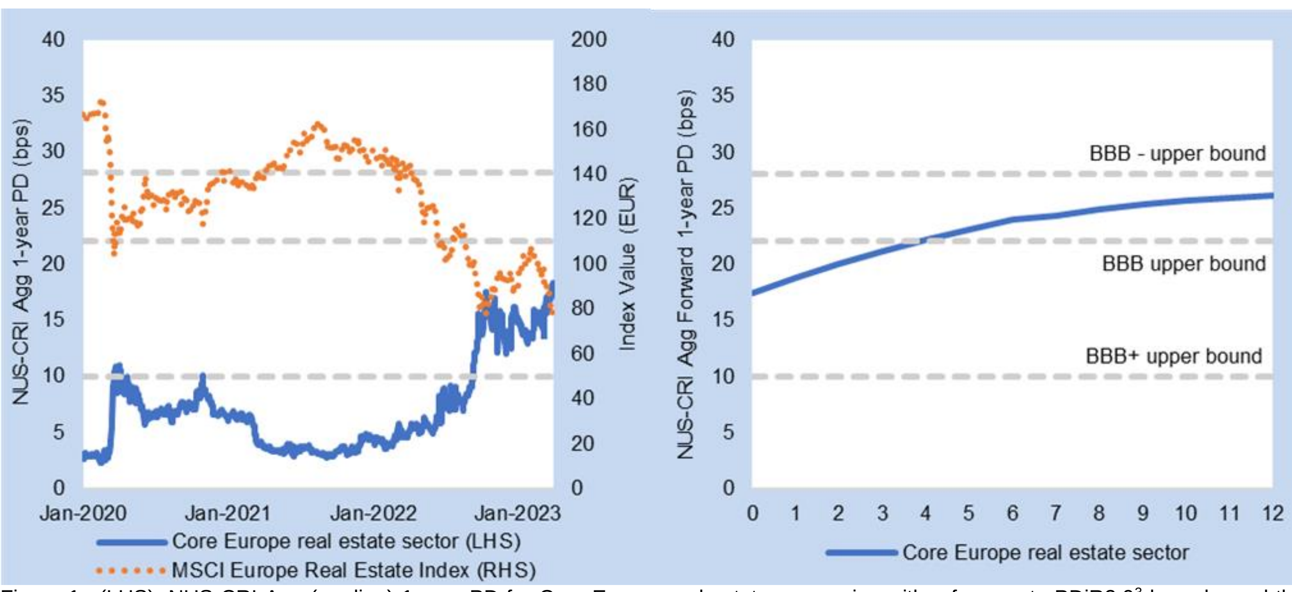

Figure 1a (LHS): NUS-CRI Agg (median) 1-year PD for Core Europe real estate companies with reference to PDiR2.0[3] bounds, and the MSCI Europe Real estate index. Figure 1b (RHS): NUS-CRI Agg (median) Forward 1-year PD for Core Europe real estate companies with reference to PDiR2.0 bounds. *Source: NUS-CRI*

[1] The core European countries consist of Germany, France, Italy, Belgium, Luxembourg, and the Netherlands.

[2] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similarly to a forward interest rate. For example, the 6-month Forward 1-year PD is the probability that the firm defaults during the period from 6 months onwards to 18 months – this is conditional on the firm's survival in the next 6 months.

[3] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation by mapping the NUS-CRI 1-year PDs to the S&P letter grades. The method targets S&P's historical credit rating migration experience exhibited by its global corporate rating pool instead of relying solely on the reported default rates.

Concurrent with the European Central Bank (ECB)'s interest rate hikes, the Agg PD of the core Europe real estate sector has been rising. Rising borrowing costs have resulted in a decline in demand for all property types.[4] Rising funding costs and declining demand pose a substantial threat to the real estate sector as capital availability and property valuations both come under pressure. Access to capital markets also remains curtailed as investors demand higher yields in the current financing environment. The cost of borrowing for the sector has already doubled as compared to the previous year, burdening the sector with higher debt-servicing costs and exposing it to considerable refinancing risk. To raise capital, the companies in the sector may be forced to resort to distressed asset sales that may further exacerbate the decline in property values.

The recent banking crisis compounds the woes faced by the heavily debt-reliant real estate sector, as banks limit credit extension amidst record-high deposit withdrawals. For instance, German banks are known to lend up to 80% of the property value as compared to 60% in the rest of Europe, and thus a decline in property value increases the LTV ratio and pressures banks' asset quality in the face of widespread corporate defaults.[5] Furthermore, the banking crisis may push banks to tighten lending standards amid a wider risk-off sentiment, while simultaneously increasing the scrutiny and screening of heavily indebted companies, potentially reducing the credit lines available. This may reduce the real estate sector's ability to refinance maturing debts over the coming year, possibly suggesting the rising term structure of the Forward PD in Figure 1b.

Figure 2a shows stress tests conducted using the NUS-CRI Bottom-Up Default Analysis toolkit (BuDA Toolkit[6]) to measure the sensitivity of the real estate sector's Agg PD to worsening credit conditions. An uptick in EU banking CCI[7], driven by the ongoing banking crisis and an unfavorable macroeconomic environment, could lead the sector's Agg PD to rise by close to 10bps over the next two years. Residential owners and developers are also likely to be more susceptible to worsening credit conditions, compared to commercial real estate developers (CRE). The effect is even more pronounced for vulnerable companies (those with PD above the 75th percentile), possibly due to the deteriorating credit conditions having a larger effect on their relatively weaker capital base and liquidity position.

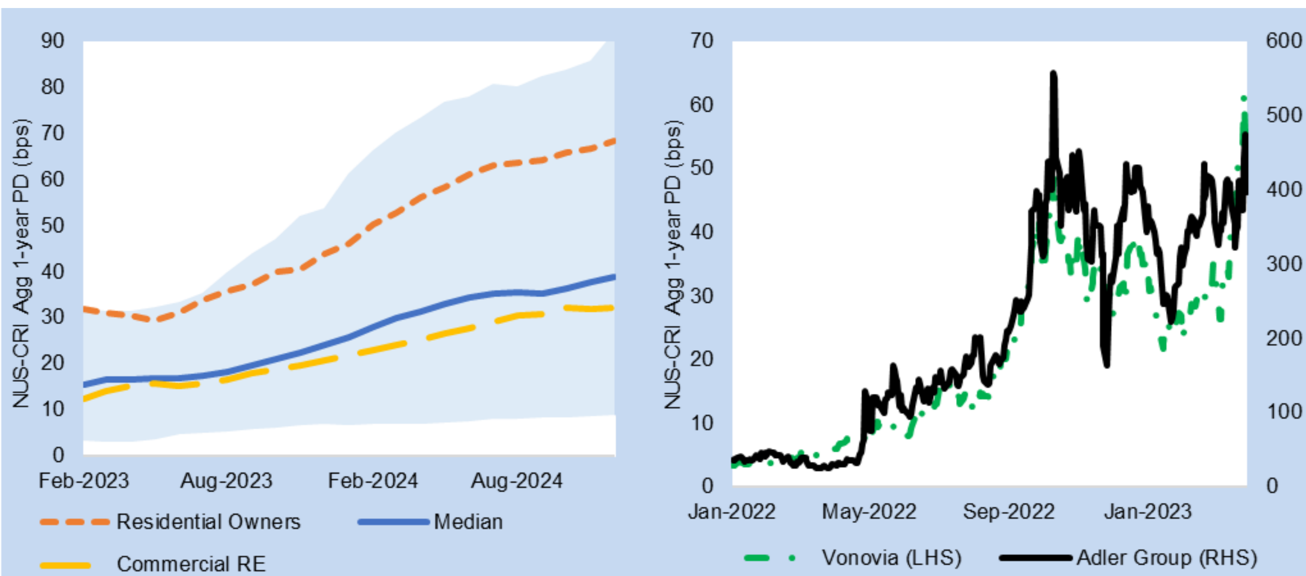

Figure 2a (LHS): Stressed NUS-CRI Agg (median) 1-year PD for core EU real estate sector and its interquartile range, core EU residential owners and developers and Core EU commercial RE developers based on stress tests conducted using EU Banking CCI. Figure 2b (RHS): NUS-CRI Agg (median) 1-year PD for Vonovia SE and Adler Group SA. *Source: NUS-CRI, BuDA v3.5.1*[8]

The residential real estate segment bore the brunt of rate hikes with dropping transaction volumes. For example, two German property giants in the residential property sub-sector, Vonovia SE and Adler Group SA credit risk spiked over the past year. In the face of rising borrowing and servicing costs, their highly indebted balance

[4] As per the Jan-2023 Eurozone banking survey, demand for housing loans declined by the highest rate on record driven by higher interest rates, lower consumer confidence, and recessionary expectations. Similarly, CREs prices have seen a consistent decline since the ECB embarked on its rate-hiking cycle.

[5] In case of a severe decline in property values, if the value of the property as collateral falls below an agreed threshold, terms in certain loan agreements may authorize banks to sell it to cut losses and replenish liquidity in time, driving down property values further.

[6] The Bottom-up Default Analysis (BuDA v3.5.1) is a credit stress testing and scenario analysis toolkit jointly developed by the Credit Research Initiative (CRI) team of the National University of Singapore (NUS) and the International Monetary Fund (IMF).

[7] The scenario estimates for EU banking CCI move from 1.11bps to 3.92bps over the next two years as suggested by the Forward 1-mont PD of Eurozone Banking sector.

[8] The Bottom-up Default Analysis (BuDA v3.5.1) is a credit stress testing and scenario analysis toolkit jointly developed by the Credit Research Initiative (CRI) team of the National University of Singapore (NUS) and the International Monetary Fund (IMF).

sheets have led to a heightened risk of default. Vonovia, which accumulated debt in the process of acquiring a rival, now finds itself squeezed by the rising cost of servicing that debt. On the other hand, Adler has warned of possible insolvency unless its debt restructuring plan is approved by a court.

The prolonged COVID-19 pandemic has also brought structural changes to the demand for CRE, especially office properties due to the updated labor market, as more employees choose to work from home. Simultaneously, a looming liquidity crunch is ringing true as Real Estate Investment Funds (REIFs), which act as significant capital providers for CREs, are also exposed to a flight of funds that may lead to a "liquidity mismatch" similar to that seen in the banking crisis.[9] Suffice it to say, the credit risk outlook for the core Europe real estate sector faces substantial risks in the near future. With access to financing channels dwindling in the short term, a potential rapid increase in asset sales in order to raise funds is likely to deteriorate the property market further. The possibility of the ongoing banking crisis leading to a potential property market crisis is likely to depress the outlook further, contributing to a build-up of systemic risk in the financial system and contributing to the rise in Forward PD in Figure 1b.

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[9] In addition, some REIFs have utilized leverage to finance their "buy-to-rent" real estate investments on a large scale.

China's top lenders tout limited exposure to western banking crisis

Apr 02. China's largest banks, including the Industrial and Commercial Bank of China, China Construction Bank, Agricultural Bank of China, and Bank of China, have reported that they have escaped direct damage from the recent financial crisis in the US and Europe. Despite the scrutiny of stress testing against potential new risks, these banks have only reported limited exposure to the failing US and European banks. Although Chinese banks have shown resilience in their credit books, their cash management and liquidity are still under market concerns. The management of the Bank of China announces that the bank has not been hit by the crisis but still plans to adjust offshore assets and deposits. (FT)

Korea braces for more loan failures amid global banking slumps

Mar 29. The governor of South Korea's Financial Supervisory Service has stated that the country's real estate market slump could lead to defaults on project-financing loans. However, the authorities have assessed over 5,000 real estate projects relying on these loans and are prepared to act swiftly following a crisis that occurred last year when a theme park developer defaulted. The governor indicated that the government aims to spread out the effects of any defaults gradually and contain any systemic problems in the economy and financial markets. The Korean banking system is considered to have sufficient buffers and limited securities exposure, so the risk of a massive bank run is low. (Bloomberg)

Egypt jumbo hike too small to beat inflation, bond buyers say

Mar 31. The recent 200bps interest rate hike by Egypt's central bank has failed to satisfy bond investors who are pressuring for more measures to tackle inflation and revive the country's financial markets. The rate increase is lower than the 300bps anticipated by the market. In February, inflation in Egypt surged to 31.9%, far exceeding the targeted rate, causing yields on pound-denominated government bonds to surge. Investors are urging greater currency flexibility, despite the government's commitment to a more flexible exchange rate since October. However, the country has experienced long periods of stability following short-lived bouts of volatility and steep downturns. (Bloomberg)

Mortgaged landlords face falling profits and refinancing hurdles.

Mar 31. The increase in mortgage interest rates has put pressure on rental property investors, particularly those heavily dependent on mortgage finance. This has led to a situation where buy-to-let landlords in 92 local authorities in England and Wales, which account for more than a quarter of all councils, are likely to face difficulties in turning a profit. According to a report by Hamptons International, roughly 8% of landlords who own 450,000 rented homes are at the greatest risk of financial strain, particularly those in areas with lower rental yields. Older buy-to-let investors with more housing equity have benefitted from interest rate rises, while younger investors with less capital and who entered the market in the past five years face greater financial pressure. (FT)

After Adani's crisis, India's Vedanta looks vulnerable too.

Mar 31. Following Adani Group's recent troubles, miner Vedanta Resources is also facing market uncertainty, which could result in increased scrutiny of other indebted Indian companies. Vedanta Resources, based in London and with several billion dollars in debt, depends on transfers from its Indian subsidiary, Vedanta Ltd. Moody's downgraded the company's debt to junk bond territory, stating that it requires approximately USD 4bn in cash to pay off debt and interest due by March 2024. Despite Vedanta Ltd.'s announcement of USD 4.6bn in dividends in the past 12 months, which is double the previous fiscal year, it faces higher leverage and lower financial flexibility due to significant dividend payments to the parent company. (WSJ)

Top India fund manager makes contrarian bets on short-term bonds (Bloomberg)

MUFG delays AT1 bond sale to after mid-May post-Credit Suisse (Bloomberg)

Hospitals hit troubling milestone in most 1Q defaults Since 2011 (Bloomberg)

Regulatory Updates

European Central Bank calls for clampdown on commercial property funds

Apr 03. The ECB has warned of the risks posed by commercial property funds, which could lead to a liquidity crisis if investors rushed to withdraw their money. In a macroprudential bulletin, the ECB called for policies to be developed to address the structural vulnerabilities of such open-ended property funds, which are exposed to a "liquidity mismatch". The report cited the recent turmoil in the banking industry and declining market liquidity and price corrections as clear signs of vulnerability. The ECB's proposals aim to manage spikes in liquidity demands and internalize the cost of redemptions that can arise during market stress. (FT)

Bullard says oil surge might make Fed's job more difficult

Apr 03. James Bullard, President of the Federal Reserve Bank of St. Louis, has stated that the recent unexpected increase in oil prices could make the inflation battle more challenging, though he believes it is uncertain whether this will have a lasting impact. While acknowledging the potential importance of the shift, Bullard also said that an increase in oil prices this year was consistent with his economic outlook for more demand for energy. He added that Wall Street is putting too much emphasis on the idea that banking turmoil will increase and fundamentally alter the economic outlook. The Fed has adopted a two-pronged strategy that uses macroprudential tools to deal with banking issues while continuing to deploy monetary policy to try to reduce inflation. (Bloomberg)

Rules on listing Coco bond ETFs changed after first approvals (FT)

Recent bank rescues a 'game changer' for financial regulators, City bosses say (FT)

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