




ANALYSES ET SYNTHÈSES

-  French banks' financing of property market professionals in 2013



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Abstract:

- Although economic conditions remained difficult in 2013, the annual survey conducted by the General Secretariat of the *Autorité de contrôle prudentiel et de résolution* (SGACPR) revealed that the amount of new loans granted by French banks to professionals in the property sector¹ rose year-on-year (+5.5%). This increase was driven by two main components: new lending to overseas professionals (+19% in Europe alone) and new lending to property investors and property companies (+3%). Trends in new lending varied across banks, however, with some continuing to cut back loan production, and others boosting their activity over the year.
- After declining by 2.9% in 2012, French banks' exposure to property sector professionals stabilised in 2013, inching up just 0.5% year-on-year. Their exposures were concentrated primarily in France (68.8%) and, outside France, in the European Union (notably Italy and Belgium) and the United States. As in 2012, exposures were concentrated on investors and property companies. A breakdown of exposures by sector shows that the vast majority of outstanding loans were used to finance residential property (40.9%), followed by office space (17.5%), and then commercial premises in third place (14.9%).
- Bank's lending criteria reflected the ongoing difficulties in the economic environment: after tightening steadily over the past few years, they remained unchanged in 2013 or were tightened further, particularly for property developers and borrowers in sluggish foreign property markets.
- The average quality of banks' exposures stabilised in 2013: after hitting a peak in 2010 and then falling in the two subsequent years, the non-performing loan ratio remained relatively high in 2013 (8.3%), up slightly versus 2012. In parallel, the coverage ratio increased to 37%, the highest since 2008.
- French banks again sold off high volumes of illiquid legacy assets from the financial crisis, and have thus reduced their exposure to this type of asset.

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¹ See "Methodology" for a definition of property sector professionals.

Methodology

- ❑ The following article is based on the responses received to the SGACPR's 2013 annual survey on the financing of property sector professionals.
- ❑ The survey is sent to the main French banks,² and is designed to collect data on their loan production and their outstanding exposures to professionals in the property sector. It also asks for qualitative data on subjects such as their commercial policy and risk management system, along with their view of the markets and their outlook.
- ❑ The survey covers all types of outstanding exposures (including credit, leases and similar financing, and credit derivatives) to professionals operating in the property sector (developers, investors, legal entities, property companies, etc.), including exposures to entities owned and consolidated by the banks themselves, and which are intended to finance property development transactions and investments, notably investments with a view to renting out and refurbishing a property. It therefore excludes property-related commitments to private borrowers (home loans) as well as loans to non-financial companies used to finance the acquisition or construction of real estate (hotels, shopping centres, leisure centres, production plants, etc.) for their own use. It also excludes property market intermediaries (estate agents).
- ❑ The survey looks at the provision of financing by France's main banks to professionals in the real estate sector. As a result it does not take into account other, non-bank sources of financing used by these professionals such as capital markets or financing from alternative financial players.
- ❑ The data used in this article only go back as far as 2008. Due to differences in scope in the surveys conducted prior to 2008, it was not possible to construct reliable longer-term data series.

² BNP Paribas (BNPP), Société Générale (SG), Crédit Agricole Group (GCA) – Caisses Régionales de Crédit Agricole and LCL –, Groupe BPCE (GBPCE) and Groupe Crédit Mutuel (GCM) – CIC and Banque Européenne du Crédit Mutuel (BECM).

1. Trends in professional property markets in 2013

This section looks at the main trends in property markets. It is divided into two parts: the commercial and residential property markets in France, and the main foreign markets in which French banks have a presence.³

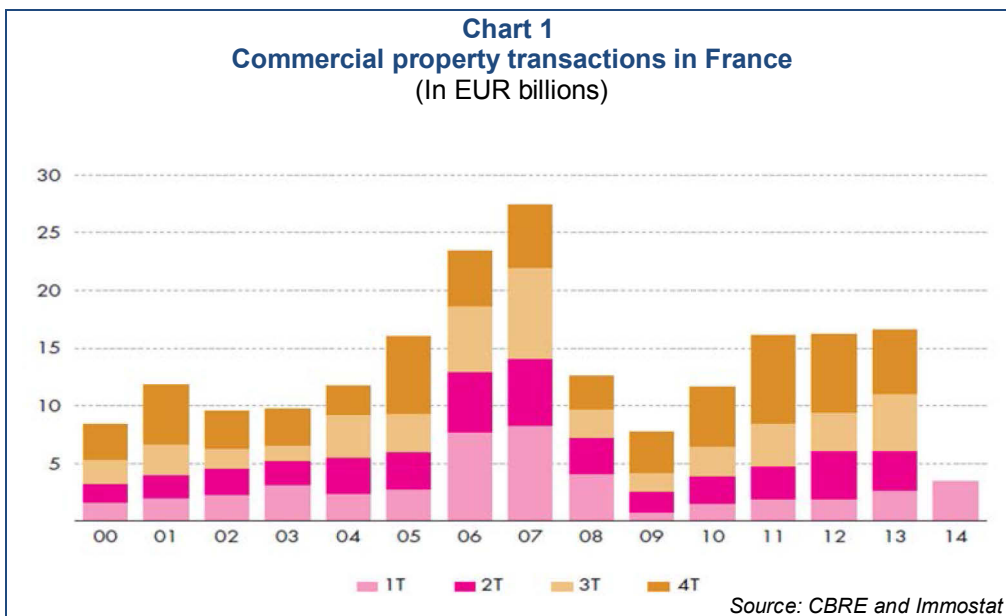
1.1. The French commercial property market

The French commercial property market remained resilient in 2013,⁴ despite the continuing depressed economic environment.

1.1.1. Stable investment volumes in 2013

Investment in French commercial real estate totalled some EUR 15 billion in 2013, which was more or less in line with the levels seen in the two previous years (Chart 1). This stability is in part related to inflows from French and international investors looking for low-risk and profitable long-term investments. As in 2012, the market was bolstered by a few notably large transactions in 2013 (exceeding EUR 100 million), the majority of which were in the Ile de France region.

The Ile de France region continued to account for the lion's share of commercial property deals in France, attracting $\frac{3}{4}$ of total transactions. The share of transactions in provincial markets rose slightly over the year, to 23%.



1.1.2. Office space continues to dominate the market

³ Summary based on various market analysis reports (see list in the appendix) and responses from banks questioned as part of the annual survey.

⁴ The commercial property sector (investment in rental property) comprises the following segments, in descending order of investment volume: offices; retail outlets and leisure and healthcare premises; followed by industrial/business premises which account for the smallest share of investment.

Offices remained the most popular asset class in 2013, accounting for 62% of transactions by value – virtually unchanged on the previous year. However, performances within the sector varied, with the Ile de France, especially its main business districts, attracting much higher levels of activity than the rest of the country. Retail outlets, the second most popular segment, remained buoyant in 2013, accounting for 18% of transactions by value. Lastly, industrial/business premises and logistics platforms were the least popular, accounting for 6% of transactions.

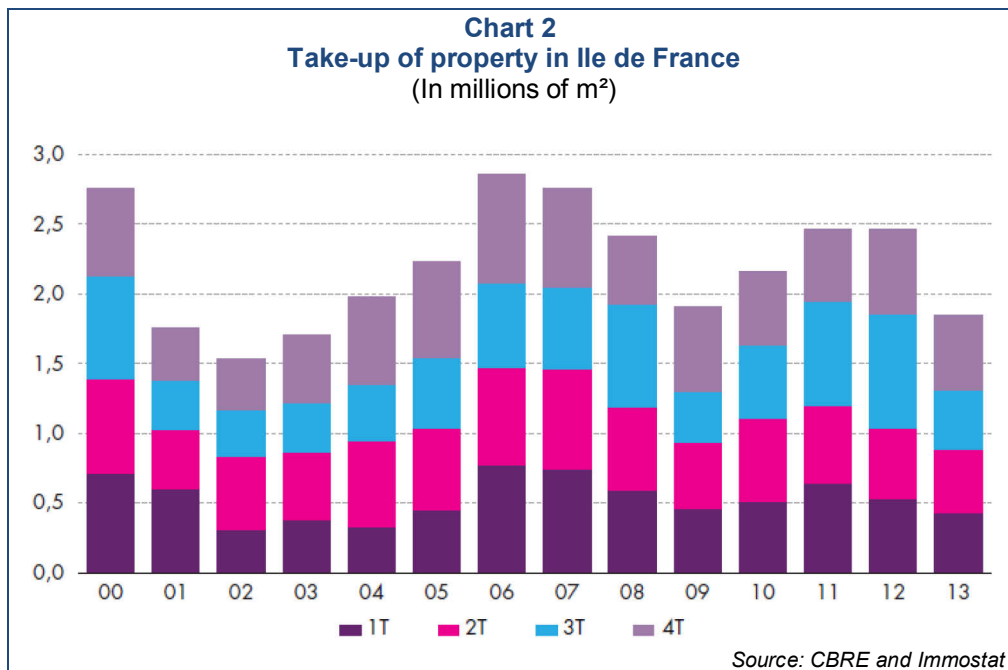
1.1.3. A busy year for French investors

Domestic investors continued to account for the bulk of activity in 2013, carrying out 60% of transactions, 5 percentage points more than in 2012. The main investors in this category were insurance companies and property investment companies. Among other investors, French investment funds were particularly dynamic in 2013, while property companies were less active, making a net reduction in their office investments.

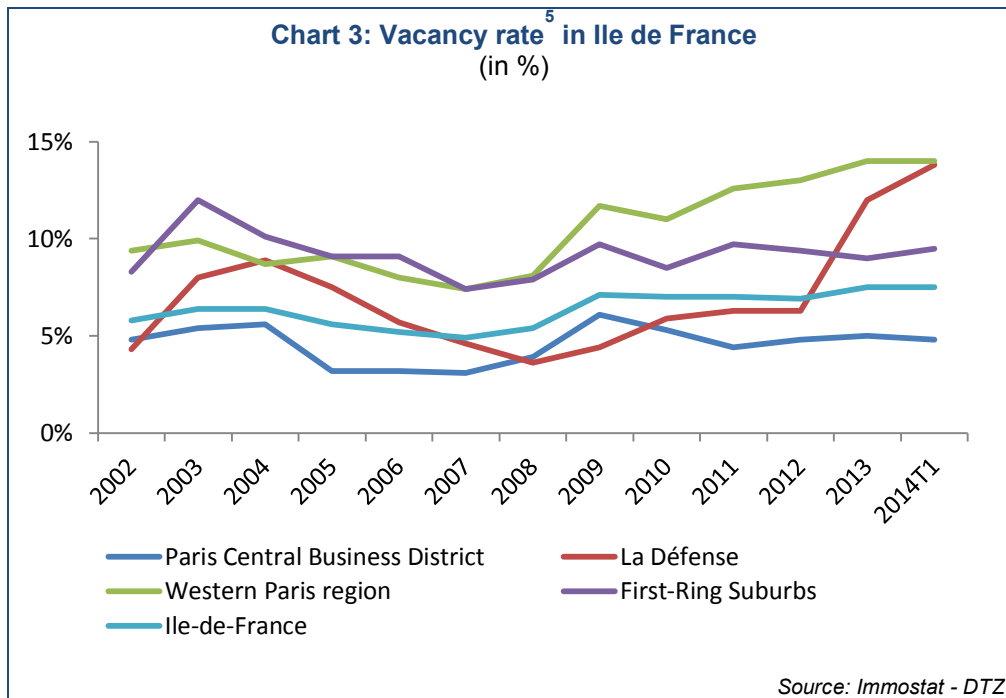
International investors accounted for 40% of office transactions in 2013, down 5 percentage points versus 2012. One notable trend was the increase in deals by North American investors, who were probably seeking high-return investments in the current low interest rate environment.

1.1.4. Lower activity levels in commercial property in Ile de France

In Ile de France, a total of 1.9 million m² of commercial property were transacted (let or sold) in 2013, 25% less than in 2012, and only slightly above the level seen in 2003 (Chart 2). The decline was due primarily to a sharp drop in deals exceeding 5,000 m².



The stock of available premises in Ile de France rose slightly to 3.9 million square metres over the period. This was due to high volumes of deliveries/tenant departures, notably in new and refurbished properties, after four years of falls, in a context of continuing subdued demand. The vacancy rate in Ile de France rose to 7.5% at end-2013, its highest level since 1998 and above the long-term average of 6% for the period 2004-2013, albeit below the peak of 1994 which followed the 1993 recession. However, the figure masks significant disparities, with central Paris – where demand is structurally high - registering a vacancy rate of just 4.8%, and the immediate suburbs and Western Paris region registering higher rates of 8.8% and 12.3% respectively – pointing to excess supply (Chart 3).



1.1.5. A sharp divergence between prime and non-prime assets

The market is splitting in two, with prime assets⁶ (new and refurbished) on the one hand attracting high demand, and second-hand assets posing a high risk of obsolescence and of vacancy. In a highly competitive market, yields⁷ on prime assets remained under pressure in 2013, falling to an average of between 4% and 5% in Ile de France and between 5.5% and 6% in the rest of the country.

1.2. The French residential property market

1.2.1. Fall in transaction volumes and prices in 2013

In 2013, transaction volumes fell both in the second-hand (decline of 5.1% relative to 2012) and new housing markets (sales reserved in new housing developments fell by 1.3%). This was due both to limited supply and to a fall in demand. However, the fall in transaction volumes did not lead to a similar decline in house prices.

⁵ Vacancy rate: ratio between the stock of property that is immediately available (to rent or buy) in m² and the total stock in a given geographical area.

⁶ Prime assets are those located in the business districts of large towns and cities. They have no technical problems and are rented out to solvent tenants.

⁷ The investor's yield is the ratio between the income derived from the property asset and the capital invested in its acquisition (acquisition price + fees and transfer taxes).

According to national statistics agency INSEE, prices for France as a whole contracted by 1.8% versus 2012 in the second-hand market, although the decline was more marked in the Ile de France region (-1.6%) than in the rest of the country (-1.3%). Average sale prices for homes in new housing developments contracted by a modest 0.1%⁸ across France, averaging EUR 3,870 per square metre at end-2013. This figure nonetheless masks significant disparities across regions: the Ile de France experienced a 3.7% drop in prices in 2013, while other areas saw a rise (+3.3% in Provence-Alps-Côte d'Azur).

1.2.2. Contraction in the property development market

Private reservations of homes fell 1.3% in 2013 to a total of 87,700 units, a level well below the average for the period 2000-2011 (103,000 units). To adapt to the ongoing depressed conditions in the market, property developers sharply reduced the number of homes released for sale. As a result, the stock of available housing stabilised, albeit at a relatively high level (in excess of 100,000 houses).

1.3. International property markets

2013 saw contrasting trends in the main international markets where French banks are present.

In Europe, the commercial property market was fairly dynamic, with investment increasing 17% to a total of EUR 139 billion.⁹ The United Kingdom, France and Germany together accounted for two thirds of this amount, whereas southern Europe saw continued low volumes of activity, despite renewed interest in the Spanish market from major international investors in the second half of the year. This led to contrasting yields on prime office property, which are generally inversely proportional to prices: in London, yields fell to an historical low of 4%, close to 2007's level, whereas in Milan and Madrid they remained high at 6.2% and 5.6% respectively. Among the major capitals, the London market saw another year of robust activity, with investment rising 38% and 94% respectively in the office and retail sectors, driven by strong inflows of foreign capital.

In the residential property market, prices continued to rise in the United States in 2013 (+10.6%), helped by the gradual recovery in the US economy. In Europe, however, the lack of improvement in the macroeconomic outlook led to further falls in prices, particularly in Italy and Spain. The United Kingdom stands out as the exception in the European housing market, with house prices rising 3.1% over the year, confirming the trend already observed in 2012.

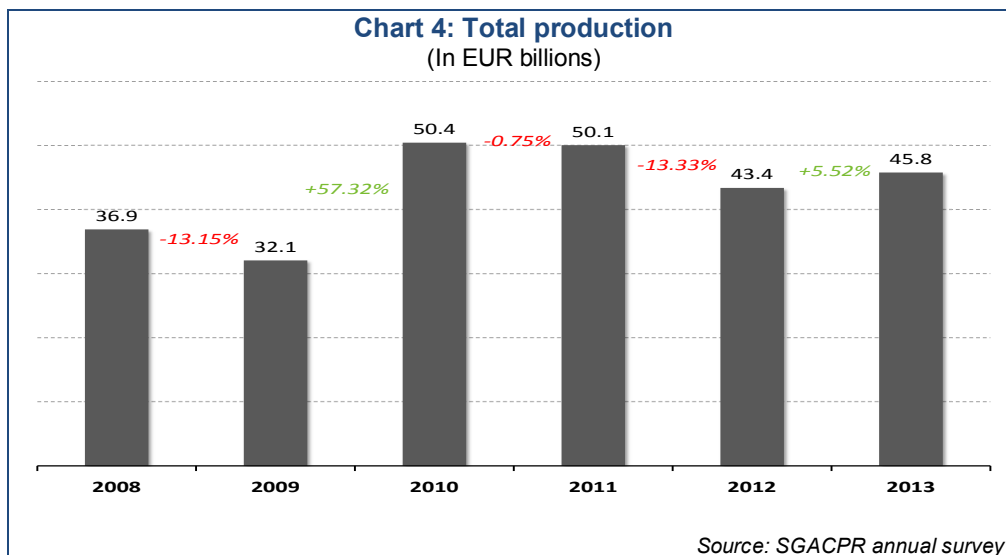
⁸ Source: French Sustainable Development Commission - Observation and Statistics Department.

⁹ Source: DTZ Research.

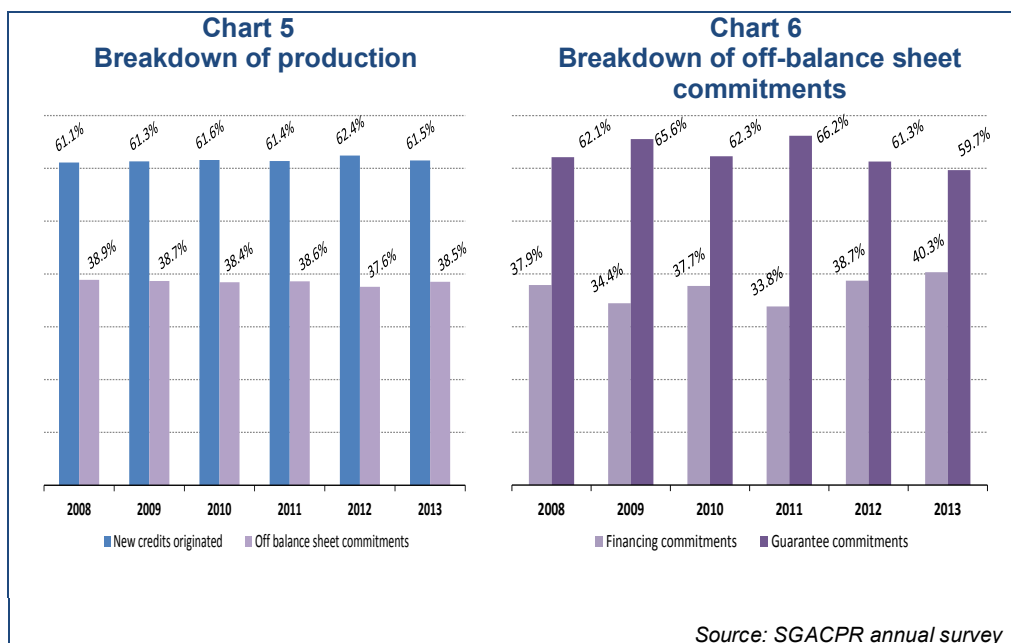
2. Analysis of loan production to property market professionals

2.1. Moderate rise in production

In 2013, overall production amounted to EUR 45.8 billion, up 5.5% compared with the previous year (Chart 4). This modest rise nonetheless masks divergences between the major French banks: some began to step up their activity in 2013, while others continued to cut back on production in order to refocus on their core activities.

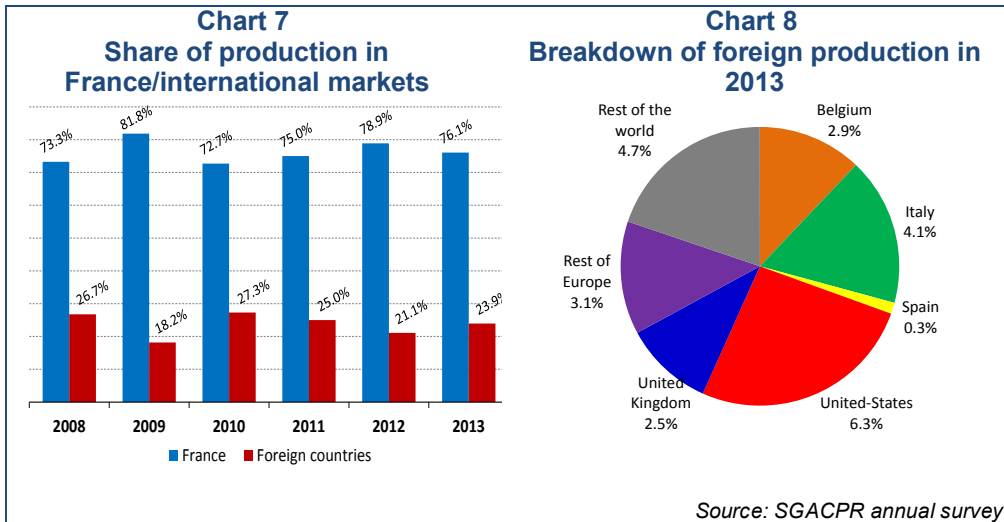


Just over 60% of total production took the form of new loans— a share that has remained relatively stable over time (Chart 5). The remainder took the form of off-balance sheet commitments, of which the majority were guarantees (59.7%) – although the latter have declined slightly since 2011 as a share of total production (Chart 6).



2.2. Slight decline in the share of production in France

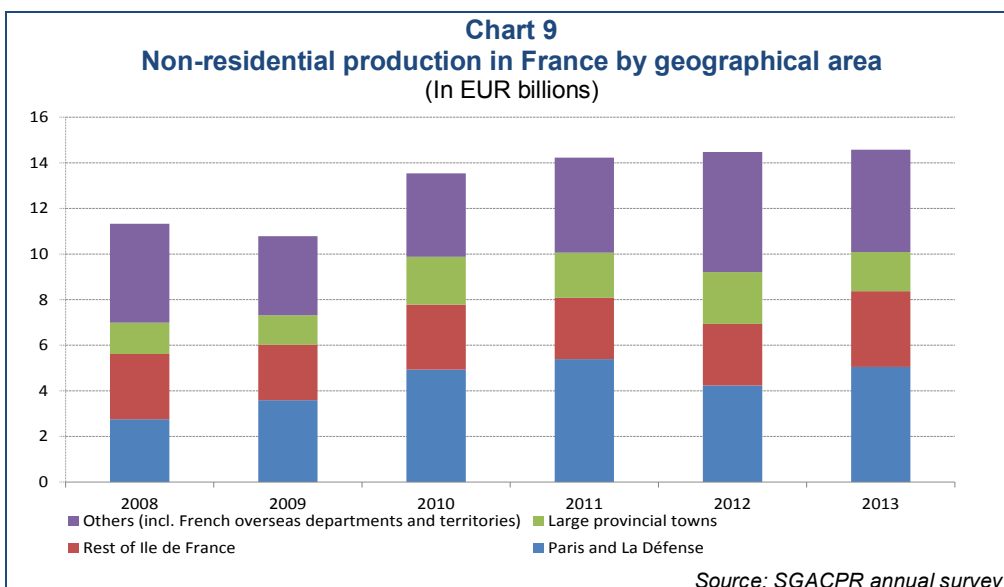
France continued to account for the majority of production in 2013, although its total share fell for the first time since 2010 (Chart 7). In contrast, the proportion of loans granted in foreign markets rose by 3 percentage points over the year, from 21.1% to 23.9%.



In 2013, international production (Chart 8) was primarily concentrated in Europe (12.9%), notably Italy (4.1%) and the “Rest of Europe” (i.e. excluding Belgium, Italy, the United Kingdom and Spain). Outside Europe, the United States accounted for the largest share of production. Only Belgium (2.9%/+0.9 percentage points), the United Kingdom (2.5%/+0.3 percentage point) and the Rest of Europe (3.1%/+0.4 percentage point) saw a rise in their share of production in 2013; Italy’s share declined by 0.4 percentage point while the US’s contracted by 0.6 points to 6.3%.

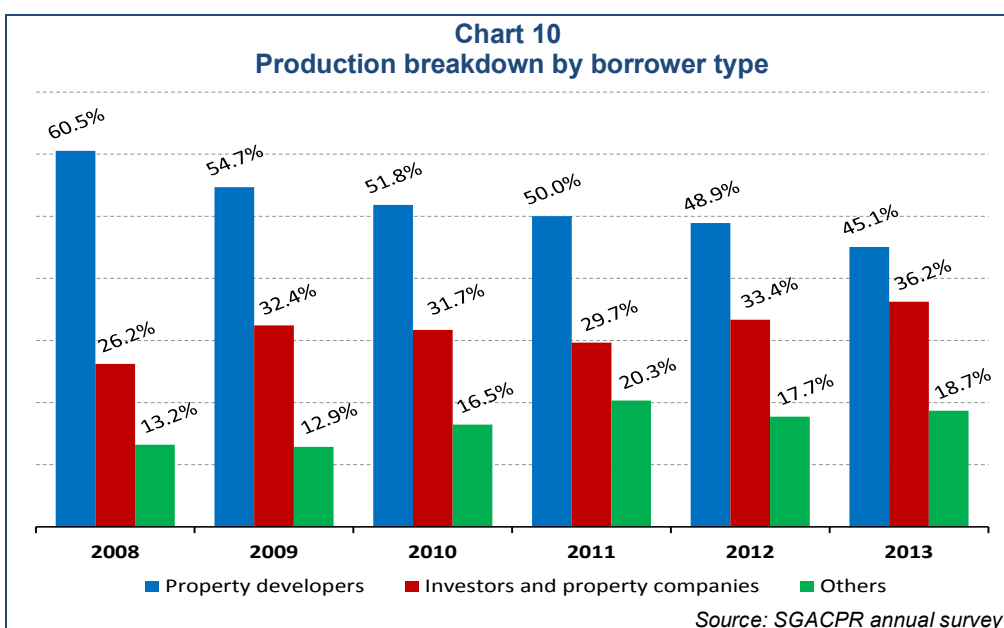
In general, the banks surveyed said they remained cautious and selective in 2013 with regard to the expansion of international production. This reflects continuing sluggishness in certain markets (such as Italy), but also an overall tendency towards risk-aversion among local investment teams, as well as strict management of risk exposure, which resulted in a lowering of certain country risk limits in 2013.

In non-residential production in France (Chart 9), the amount of new loans granted in the Paris and La Défense areas increased in 2013 (+19%) but remained below the peak registered in 2011. Similarly, new loans in the rest of the Ile de France region rose 23% year-on-year, while in the major provincial towns and the “others” category, it fell 24% and 14% respectively. Thus, while overall production in France remained stable in 2012 and 2013 (at EUR 14.5 billion), it tended to decline in provincial regions and increase in central areas, i.e. Paris, La Défense and Ile de France.



2.3. Continuing downward trend in financing of property developers

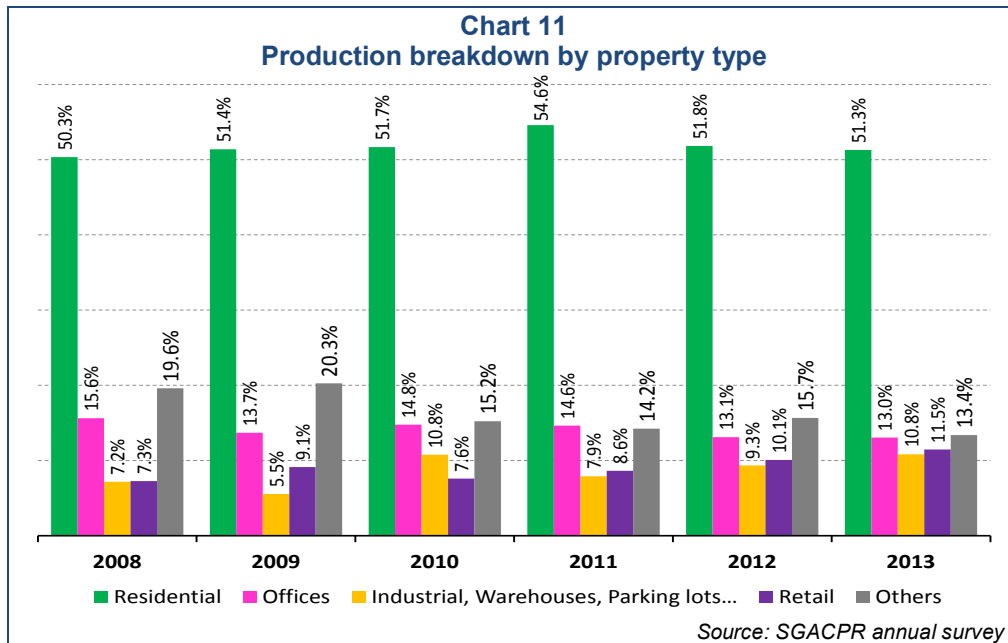
While property developers remained the main beneficiaries of bank financing (45.1% of total production), their share has tended to shrink over time, falling 15 percentage points since 2008 (Chart 10). The flip-side of this long-term decline has been a rise in the weight of investors and property companies – their share of production rose by 10 percentage points in 2013, hitting its highest level since 2008, at 36.2%. The category “other” beneficiaries¹⁰ also rose slightly to 18.7%.



¹⁰ The “others” category notably includes social housing agencies.

2.4. Residential property still accounts for the majority of production

The breakdown of production by property type has shown very little change over time: the majority of total production still goes to finance residential property (Chart 11), and this share has remained stable since 2008, at around at 51%.



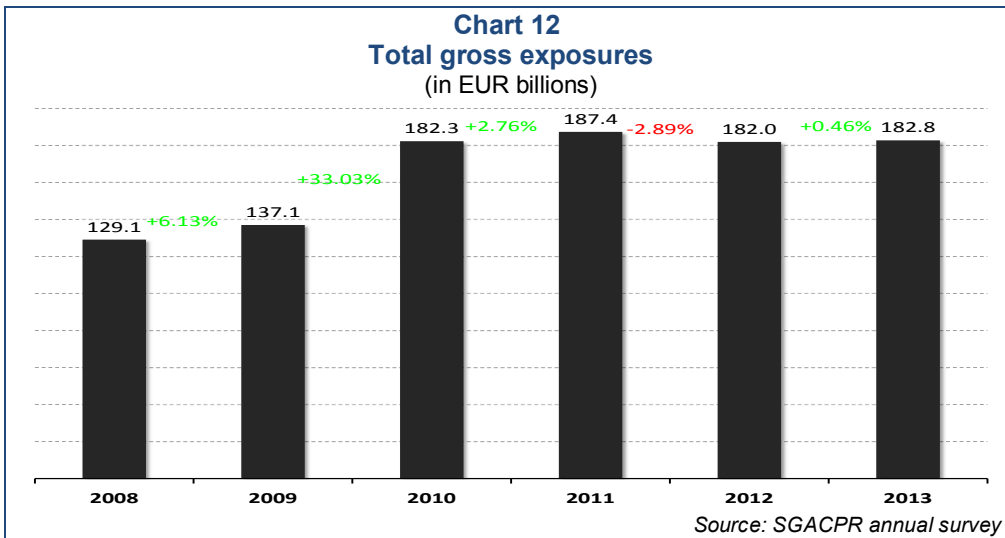
As a share of total production, non-residential property has also remained fairly stable at around 49%; within this category the most popular property types, in descending order of production, were offices, retail outlets, industrial premises and “others”.¹¹

¹¹ The “others” category comprises a wide variety of products (education premises, clinics, retirement homes, theatres, etc.).

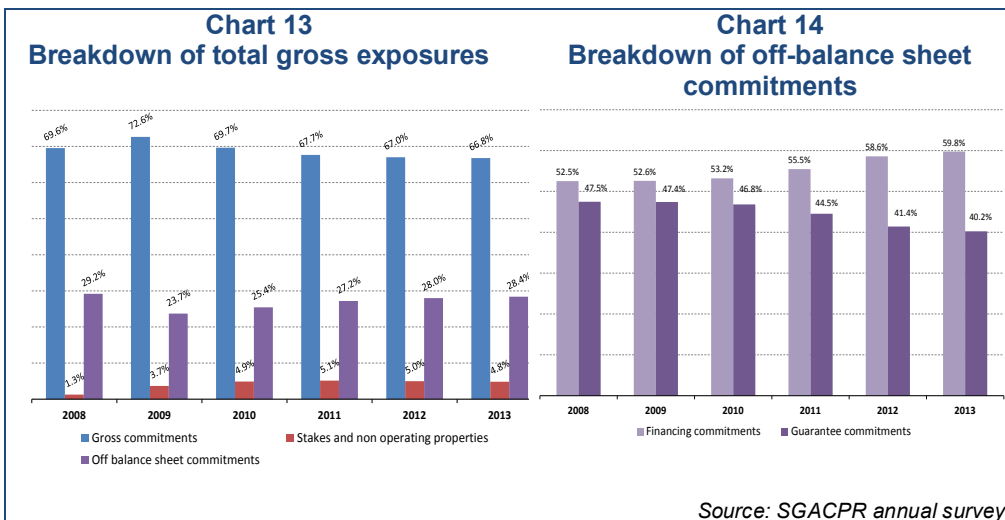
3. Analysis of outstanding exposures to property market professionals

3.1 Outstanding exposures remained relatively stable in 2013

Total gross exposures¹² remained more or less unchanged relative to 2012, totalling close to EUR 183 billion at end-2013 (Chart 12). However, this stability masks divergences between the major French banking groups: some banks saw a rise in total outstanding exposures; others, however, saw a decline because of higher rates of early repayment than in the past.¹³



Outstanding loans accounted for the majority of gross exposures, although this share has been shrinking gradually since 2009 in favour of off-balance sheet items (Chart 13). The latter are mainly, and increasingly, financing commitments (Chart 14).

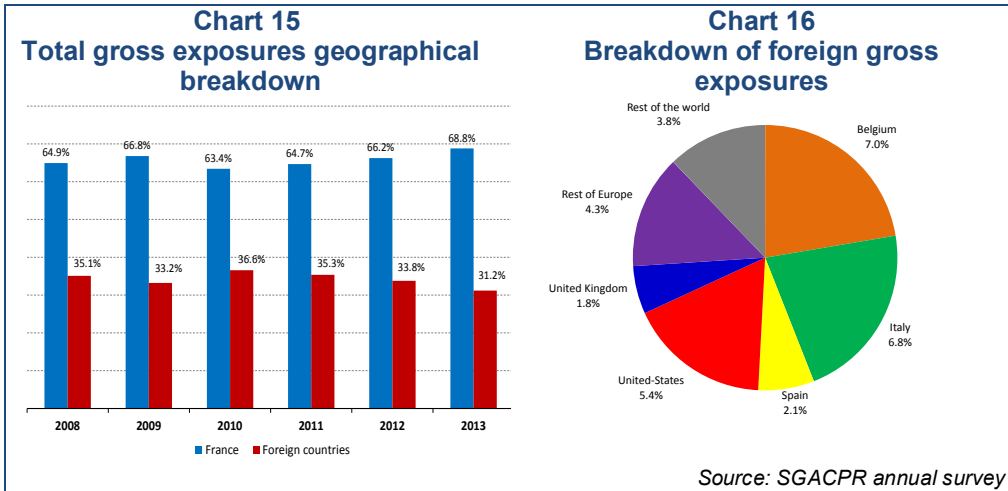


¹² Total gross exposures comprises loans and off-balance sheet commitments, as well as stakes in property companies or non-operating buildings owned directly by the banks.

¹³ Increase in the number of “alternative” lenders in the market for investment finance.

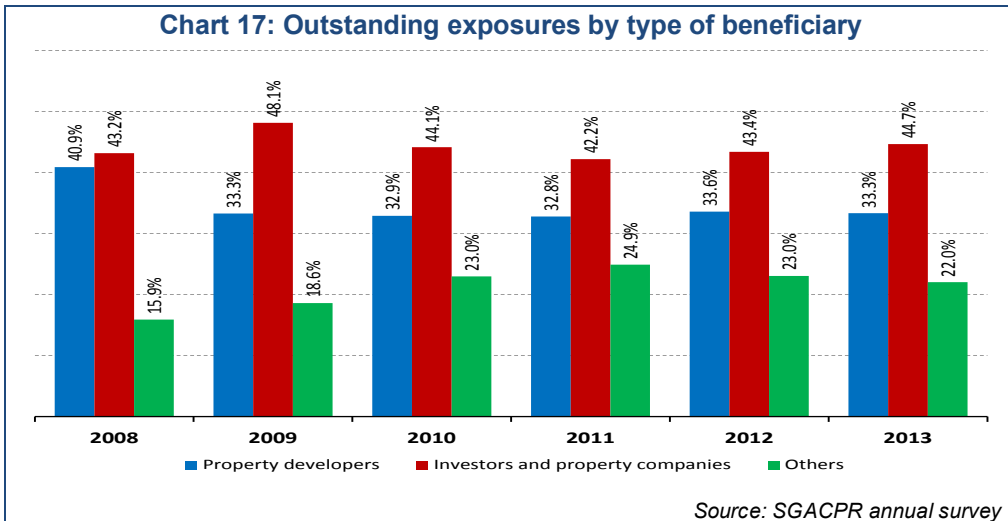
3.2 Exposures are primarily concentrated in France and Europe

The French market accounted for just over two thirds of gross outstanding exposures at end-2013, representing a rise of 2.6 percentage points versus 2012 (Chart 15). Foreign exposures were mainly concentrated in Europe (22%, down slightly versus 2012), and in particular in Belgium (7%, down 0.2 percentage point), and Italy (6.8%, down 0.7 percentage point). Outside Europe, the share of exposures in the United States shrank by 0.2 percentage point to 5.4%, while the rest of the world accounted for 3.8%, down 1 point (Chart 16).



3.3 French banks' main exposure is to property investors

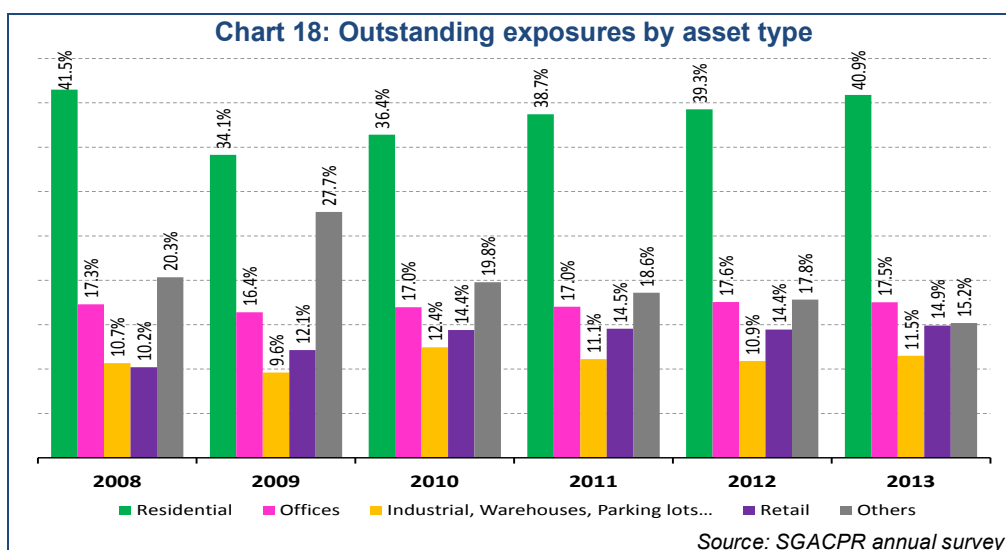
The breakdown of outstanding property exposures by type of borrower (Chart 17) was little changed versus 2012: investors and property companies were still the leading beneficiaries, with their share rising 1.3 percentage points year-on-year. As for property developers, their share remained stable at 33%, while the "others" category shrank slightly to 22%.



3.4 Outstanding exposures are mainly tied to residential property

As with production, French banks' exposures are mainly tied to the residential property sector; indeed this segment has been expanding steadily since 2009 as a share of total exposures, recouping nearly all of the heavy losses seen between 2008 and 2009 (Chart 18).

In the non-residential property sector, offices have frequently ranked in first place, accounting for around 17% of outstanding exposures; retail outlets, which rose up until 2011, have since held steady at between 14% and 15%. The “others” category has continued to decline since hitting a peak in 2009 (27.7%), and in 2013 only accounted for 15.2% of outstanding exposures.



3.5 Risk exposure remains contained

3.5.1 Lending policies

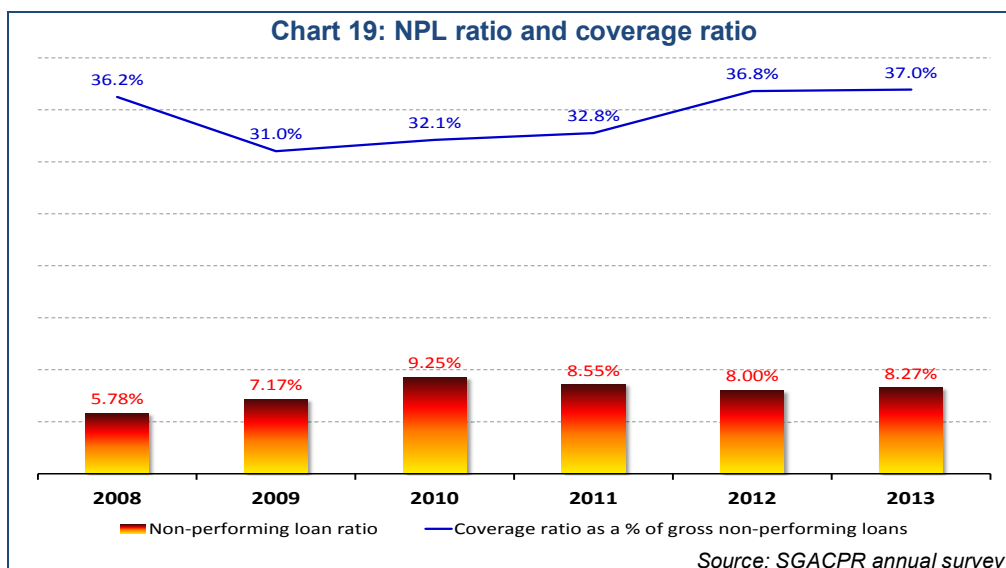
On the whole, the banks surveyed said they kept their lending criteria unchanged in 2013, after tightening them in both 2011 and 2012.

Some banking groups also adopted specific criteria to take into account difficulties in individual markets. In the residential property market, for example, the increase in selling times for some new housing developments prompted banks to raise capital and pre-sales requirements for property developers. In some cases, they also lowered loan-to-value (LTV)¹⁴ ratio limits and demanded additional guarantees. On the whole, banks maintained, and in some cases increased, the exposure limits set in 2012 for individual transactions, counterparties, sectors or countries.

3.5.2 Increase in non-performing exposures

The gross amount of non-performing loans edged up slightly in 2013 to EUR 10.1 billion (a rise of EUR 0.3 billion) after contracting for two consecutive years, but nonetheless remained below the 2010 peak of EUR 11.7 billion. As a result, the non-performing loan ratio also rose (by 27 basis points) after two years of declines, to stand at 8.27% at year-end 2013 (Chart 19); as total gross outstanding loans remained unchanged in 2013 versus 2012, this rise in the NPL ratio is entirely attributable to the increase in the amount of non-performing loans. At the same time, the coverage ratio as a percentage of gross non-performing loans (coverage ratio) continued to rise; at end-2013 it stood at 37%, its highest level since 2008. As a percentage of total exposure (performing and non-performing) the provisioning ratio was 3.5%, up 22 basis points compared with 2012.

¹⁴ The Loan-to-Value ratio or LTV is the ratio between the total amount of the loan and the market value of the financed asset.



The cause of loan defaults varied according to sector. In property development, they generally resulted from an increase in selling times for properties, higher cancellation rates and, in some areas, a fall in buy-to-let investment. For long-term investors, the defaults generally stemmed from a fall in the market value of the asset and/or downwards pressure on rents due to high vacancy rates, which usually cause the borrower to breach its LTV or interest service coverage ratio (ISCR) loan covenants,¹⁵ making the loan more difficult to refinance.

The slight rise in non-performing loans can be in part attributed to the fact that certain banks are exposed to fragile European economies, such as Spain, Italy and Greece.

3.5.3 Lower exposure to toxic or sensitive property assets

In 2013, French banks continued to reduce their exposure to toxic or legacy assets¹⁶ from the subprime crisis, and at an even faster pace than previously (exposure fell by 79%), as favourable market conditions meant they were able to step up asset sales.¹⁷ Exposure to sensitive assets,¹⁸ which has also fallen over the past three years, was reduced by a sizeable 70%.

3.5.4 Production margins remained stable overall

Production margins remained generally stable in France in 2013, despite the downwards pressure from increased competition (investment funds, insurance companies, etc.), as this was largely offset by a downward trend in the cost of liquidity.

¹⁵ Clauses in bank loan contracts specifying that if certain ratios are not met sanctions may be applied, ranging from an increase in the cost of the loan to a demand for early repayment. In the case of loans to property market professionals, these clauses generally refer to the following ratios: LTV, debt service coverage ratio (DSCR) and interest service coverage ratio (ISCR).

¹⁶ Banks' toxic real estate assets are generally shares in securitisation vehicles where the underlying asset comprises mortgage loans originated in the United States (RMBS, CMBS, CDO) or exposures to credit insurers.

¹⁷ See Table 5 in *Analyse et Synthèse* No. 29.

¹⁸ Sensitive assets are toxic assets but where the underlying asset was originated in another country, such as the United Kingdom or Spain.

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