Zombie loans: Fact or fiction?

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This article is a summary of Short Paper 20, Zombies and Beyond: A Further Update on UK Real Estate Debt, written by the author and published by the IPF Research Programme in September 2014.

Bank lending to real estate fell by over £50bn between 2009 and 2013[1] but, as predicted by IPF Short Papers published in 2009[2] and 2010[3], the distressed loan workout process has been a gradual one so there are still a significant number of 'in default' and 'high loan-to-value (LTV) loans'.

While banks have tended to concentrate on reviewing larger and more complicated loan exposures and where there are operating company issues (e.g. hotels and house builders), there has been no common approach in terms of timescale. Some banks have been reducing exposures aggressively, and looking to dispose of loans, while others have taken a longer-term approach. Generally, they have avoided both refinancing smaller loans where debt service has continued to be met and enforcement, which is perceived as a costly option. Banks have also conducted sales of portfolios of loans, driven in part by changes to bank regulation, which have increased the cost of retaining non-performing loans.

Default and high LTV loans

The year-end 2013 De Montfort University (DMU) survey, The UK Commercial Property Lending Market, identified a total of over £59bn of debt where LTV ratios were in excess of 70%, and hence considered to be a high LTV loan. While there has been a reduction of £36bn in these loans since 2011, they still represent more than one third (37%) of all the loans covered by the DMU survey, as shown in Figure 1.

Figure 1: **Current LTV ratios by proportion and value of outstanding debt**

	End-2011		End-2012		End-2013	
	%	£bn	%	£bn	%	£bn
LTV below 70%	50	96	53	93	63	99
LTV 71%-100%	30	57	24	42	18	28
LTV over 100%	20	38	23	40	19	31

Source: Survey into The UK Commercial Lending Market 2013, De Montfort University

1 **Survey into The UK Commercial Lending Market 2013**, De Montfort University, published June 2014

2 **UK Real Estate Debt – A Problem for Borrowers and Banks**, Short Paper 1, published by the IPF Research Programme August 2009.

3 **An Update on Real Estate Debt**, Short Paper 7, published by the IPF Research Programme February 2010.

This £36bn reduction is the result of a combination of debt restructurings, collateral value increases, loan amortisation and loan portfolio sales (circa £5bn) taking lending outside the scope of the DMU survey. Effectively, £31bn of loans have moved from high LTV to below 70% LTV in the past two years. If this rate were to continue, there is perhaps another four years before the legacy high LTV loans disappear.

Types of properties secured by high LTV loans

There is little data as to the nature of the properties secured against high LTV loans. However, using the general information and research available on the commercial property market and through discussions with banks and purchasers of loan portfolios, some insight has been gained into the type of properties that act as security for this category of loan.

ASSET TYPE

Given the time that has elapsed since the start of the banking crisis, and the fact that these would be non-income producing, there is little exposure to loans originally made against commercial developments. There may be some exposure to obsolete properties that have very low existing use values and, therefore, need to be redeveloped.

ASSET QUALITY

From anecdotal evidence and analysis undertaken by Frodsham and Gimblett[4], based on IPD data to end 2011, overall asset quality is assumed to be of lower or, indeed, poor quality. The high quality properties with larger lot sizes, security of income and yield tightening, together with the healthy property and lending markets for such assets are all factors that point to these having been early candidates for re-financing or sale.

GEOGRAPHIC BIAS

There is likely to be a bias towards the regions, given the comparative strength of central London and, to a lesser extent, the South East as against the provincial markets. This has been most evident in offices and residential assets, which form the bulk of the stock in London.

Such a regional bias has been less pronounced in prime assets in other sectors, with large shopping centres, in particular, having attracted investor interest.

SECTORIAL BIAS

It is difficult to draw conclusions about any sectorial bias without more data; sectors where occupational demand is weak are more likely to suffer income shortfalls and lower estimated rental values (ERVs), which will adversely affect valuations and, consequently, increase LTV levels. Evidence points to secondary retail, leisure, industrial and regional offices having been adversely impacted by the lack of occupational demand since the Global Financial Crisis (GFC).

What is happening?

There is thus still a long way to go before the UK returns to an entirely 'normal' real estate lending environment. Some £59bn of high LTV loans remains to be dealt with, which represents 37% of 'DMU' real estate loans. The overall face value of these loans, factoring in CMBS, may well be higher than that.

The large banks appear to have settled on a workout process, as opposed to creating a Northern Rock-type 'bad bank' to hold distressed assets.

4 **The Slotting Approach to IPRE Risk Weighted capital – A UK Simulation Study using IPD Data**, by M Frodsham and K Gimlett, published in 2012.

LOAN PORTFOLIO SALES

However, the increased regulatory burden on bank balance sheets has created an arbitrage that makes loan portfolio sales comparatively more attractive to banks than a longer-term, on-balance sheet, workout. Loan portfolio sales will continue to provide an exit route for banks, particularly as this market is now well-established and transparent.

Purchasers of these portfolios do not expect to achieve significant discounts to underlying property valuations but the lower cost of capital still provides an opportunity for good returns to be made. These purchasers also tend to have greater flexibility than the traditional banks, as they can more easily purchase assets from borrowers or provide additional capital where required. They are also more able to take a 'portfolio' view and will measure returns at a portfolio level rather than on a deal by deal basis.

A flavour of the size of this market is given by the February 2014 prospectus for the launch of Kennedy Wilson Real Estate Europe plc (KWRE) (formed to invest in "real estate and real estate loans in Europe"), which suggested that the combined amount of UK non-performing commercial real estate loans held by Lloyds Banking Group and RBS amounted to €65.2bn and KWRE expected RBS to sell £38bn of non-core assets between 2014 and 2017.

VALUATION IMPACTS

The long term over which workouts have been conducted/executed has had an impact on the property market. The lack of evidence in some sub-sectors may be attributable, in part, to the slow rate of workout and to the consequent valuation uncertainties, which are likely to result in pricing volatility over the next few years.

In addition, the continuing weakness in occupational demand in certain sectors will impact on the ability of owners to undertake capital investment in their vacant properties, which may result in accelerated depreciation. This, in turn, will lead to certain locations being unable to regenerate effectively.

INTEREST RATE MOVEMENT

The extraordinarily low interest rate environment has been a further factor in preventing more income defaults (even when additional costs are factored in), although, in some cases, the use of interest rate swaps has negated that benefit. The DMU study backed this up when stating that, "lenders continue to identify the crucial importance of low interest rates that keep historic loans profitable".

Rising interest rates are an indicator of a growing economy, which should, in theory, be a positive for property values. However, rising interest rates will make existing debt burdens for many borrowers more expensive to service. Rising rents, which should come from increased occupational demand in an improving economy, may not be seen until sometime after such interest rate rises occur.

INDIVIDUAL LOAN RESTRUCTURINGS

Loan sales accelerate write-offs but reduce the on-going administrative burden on banks. The use of such sales militates, at least in part, against banks undertaking individual loan restructurings since the ability to workout loans with borrowers is part of the attraction for purchasers of these portfolios: If the workout had already been conducted by the bank, there would be a more limited upside for loan purchasers.

However, given the amount of high LTV loans still remaining, lenders will have to continue to workout loans with borrowers on a case-by-case basis in order to spread losses and ensure that value is not eroded.

New capital will need to be introduced to facilitate such restructurings.

Conclusion

The pace of the loan workouts is inevitably linked to the health of the UK economy and, in turn, the UK property market. However, even in an improving environment, the scale of the loans left to be refinanced means that the original estimate of five to 10 years in IPF Short Paper 1[5] still appears reasonable.

The focus now is likely to move to those loans where 'blend and extend' has, to date, been sufficient to protect the lender's position. The current situation appears to dis-incentivise borrowers from properly investing in their portfolios, even when they have the capital to do so.

Whether remaining in the hands of banks or sold on to third parties, the answer lies in an increased awareness amongst borrowers that the status quo is not an acceptable situation. Borrowers will benefit from proactive engagement with lenders to extend loans against a background of specific performance targets, which may require the introduction of additional capital, asset sales, debt for equity swaps, profit sharing of upside or, even, just a fee for conducting an orderly workout.

5 See Footnote 2

Dates for the diary

ANNUAL LUNCH
30 January 2015
London Hilton on Park Lane
Guest Speaker: Tim Harford
Tickets: £117.50 + VAT
Contact Barbara Hobbs: bhobbs@ipf.org.uk

MIDLANDS ANNUAL LUNCH
1 May 2015
ICC, Birmingham
Guest Speaker: Steven Norris
Tickets: £75 + VAT
Contact Barbara Hobbs: bhobbs@ipf.org.uk

ANNUAL DINNER
24 June 2015
The Grosvenor, Park Lane
Bookings opening soon

SCOTLAND ANNUAL SEMINAR & DINNER
2 September 2015
Waldorf Astoria Edinburgh – The Caledonian

MIDLANDS ANNUAL DINNER
15 October 2015
ICC, Birmingham

IPD/IPF UK PROPERTY INVESTMENT CONFERENCE
19-20 November 2015
The Grand Hotel, Brighton

NORTHERN ANNUAL DINNER
26 November 2015
The Lowry Hotel, Manchester