



Banks alone can't solve refinancing challenge

At a recent breakfast hosted by JC Rathbone Associates and attended by more than 100 members of the UK commercial property industry, a panel of experts discussed the main challenge Europe's property industry faces in 2010: how to refinance an estimated \$90bn of real estate debt over the next two years.

Despite forecasts of a "tsunami of financing", this situation may be less severe than first feared, as UK bank lenders have so far shown a measured approach to maturing loans. This approach has been justified by the recent appreciation in property values, which has reduced the pressure on loan-to-value covenants.

However, banks' property lending capacity is now much reduced as there is far less capital in the banking system. It is not just property that needs refinancing; the maturity and restructuring of loans on private-equity supported deals will compete for banks' capital, while government pressure will push financing for infrastructure requirements to the head of the queue.

With banks also preferring to lend for shorter periods, property investors will need to consider alternatives to traditional bank lending.

The average duration of banks' commercial real estate loans will soon fall to around three years. Longer-term property investors are unlikely to be prepared to live with these shorter debt terms. The financial crisis has also reminded all borrowers of the benefits of diversification of funding sources.

Longer-term lenders such as Aviva and Canada Life may take up some of the shortfall from the banks. But their appetite for property lending is determined by a requirement to match their longer-term pension liabilities, rather than any enthusiasm for the market, even at enhanced margins. So they can only provide a small palliative, in the face of a flood of maturing CMBS issues.

Land Securities and Tesco have both tried more standard bond issues. But both were seen as one-off deals, carefully constructed so that the quality and tenor of the security limited the risk. Similar issues are likely to trickle out slowly, but it would

be surprising if bond markets could produce enough institutional investor demand to dent the volume of maturing bank loans and CMBS issues.

The pfandbrief solution

It is hard not to ponder whether a covered bond market along the lines of Germany's pfandbriefs would not offer an ideal solution. Some UK banks have FSA authorisation to issue covered bonds, but to produce an attractive market that will enhance high-quality investment would require a shift in UK banks' working practices. They would have to work together to produce acceptable credit criteria for institutional demand.

As in the pfandbrief market, an independent regulator would have to monitor issues to ensure credit quality. This would take some time to set up, but the rewards would seem considerable. Banks would not be able to move the loans supporting covered bonds off their balance sheets, but the Bank of England might foster this market, as the German authorities do, by reducing the capital weighting of loans funded via covered bond issues.

Fears of banks flooding the market with bad property loans have yet to be realised. But with increasing volumes requiring refinancing from 2011 onwards, as bank loans and securitisations mature, the limited capacity in the market is expected to come under increased demand.

Even simple loans now take time to finance and document, so companies should not wait until six months before their debt expires until considering how to refinance it. Debt structures should be reviewed 12 months or longer before expiry, giving time to seek alternative financing opportunities.

This review is aided by low medium-term borrowing rates, which can be offset against the rise in margins and spreads since the credit crunch and are unlikely to disappear for as long as the maturing debt pile hangs over the market.

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