

Commercial real estate markets after the end of “low for long”: Risks and policy challenges

Category: Uncategorized

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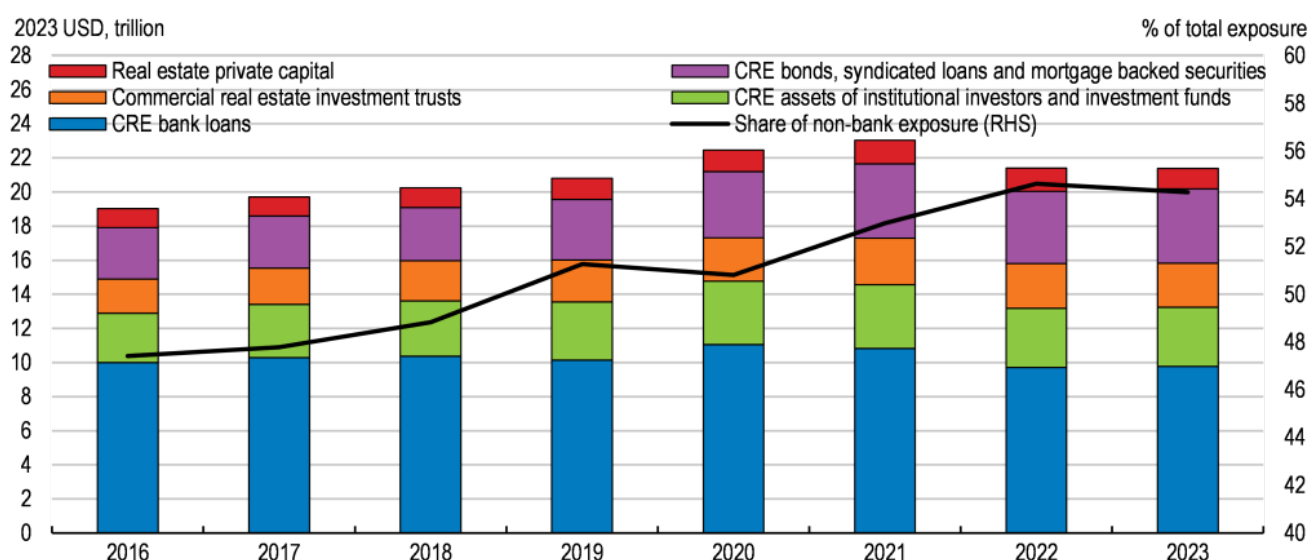
– By Caroline Roulet –

Real estate assets are the largest store of wealth in the OECD countries, valued at USD 111 trillion in 2022, nearly twice the level of GDP. Commercial buildings, plus other corporate structures, at an estimated USD 38 trillion, account for more than one-third of these assets. Conditions in many commercial real estate markets have worsened significantly since 2022, when the long period of low interest rates came to an end. Recent OECD work documents sizeable declines in commercial property prices, particularly in the United States and the euro area, driven by both higher global interest rates and changes in demand induced by growing teleworking and e-commerce. At the same time, the financing costs of property developers and risk premia for low-rated commercial mortgage-backed securities have risen, and the performance of specialised institutions such as commercial real estate investment trusts and funds has weakened.

The exposures of financial intermediaries to commercial real estate are estimated to have totalled USD 21 trillion in 2023

(Figure 1), based on available data for individual institutions across a large number of economies. Although bank loans are the largest single source of exposure, the combined exposures of diverse non-bank sources have risen over time and now exceed 50%. In particular, commercial real estate investment trusts and funds have become increasingly important over the past fifteen years, especially in advanced economies. Debt accumulation by commercial real estate investment trusts and property developers is reflected in a substantial increase in outstanding bonds and syndicated loans, and a growing reliance on private capital.

Figure 1. Worldwide financial sector exposures to commercial real estate are very large



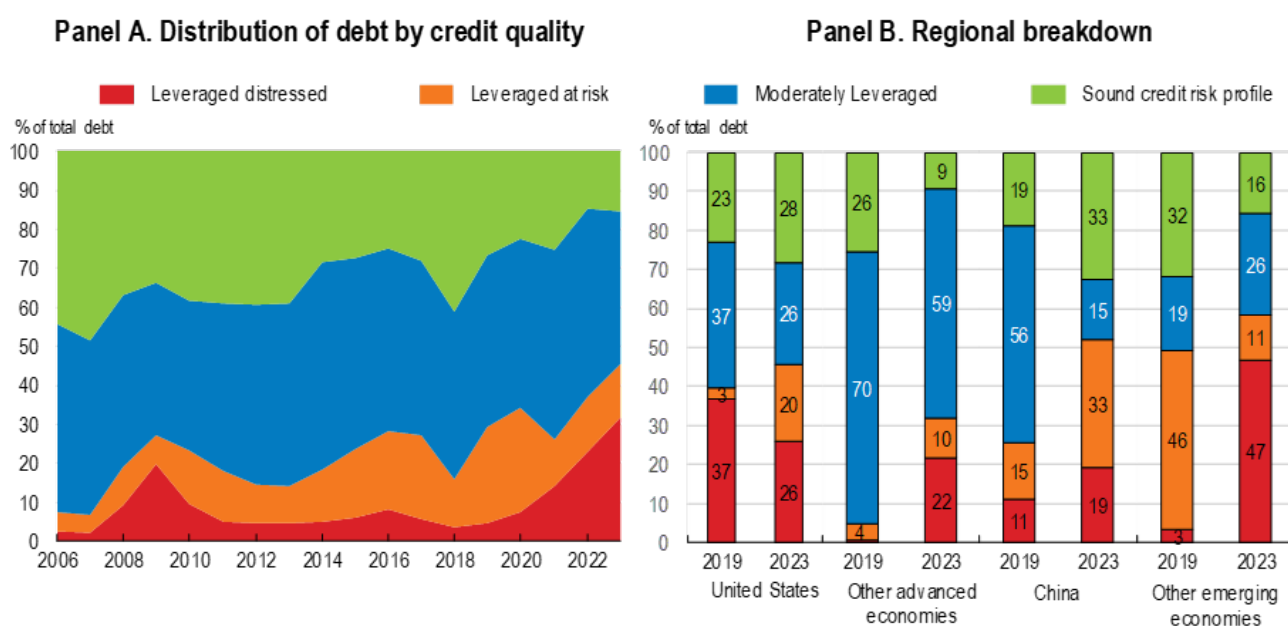
Note: This figure provides estimates of commercial real estate (CRE) exposures for both bank and non-bank financial intermediaries. Data are expressed in trillion US dollars adjusted by 2023 US consumer price index. See note of figure 1.6, Box 1 and Annex B in Roulet (2024) for further details.

Source: IMF FSI, OECD National Accounts, National central banks and office statistics, LSEG, Pitchbook, OECD calculations.

Commercial property developers face mounting credit quality challenges, with the amount of low-credit-quality debt

recently surpassing levels in the global financial crisis (Figure 2, Panel A). Developers in emerging-market economies are particularly affected, but credit quality has also deteriorated in advanced economies (Figure 2, Panel B). Moreover, the maturity profile of bond and syndicated loan redemptions implies substantial refinancing needs in the next few years, particularly for leveraged borrowers (Roulet, 2024). Delinquency rates on commercial mortgage-backed securities are also rising, amidst a growing number of missed mortgage payments by borrowers with commercial real estate loans.

Figure 2. Across the world, the quality of property developers' debt has often deteriorated



Note: Four types of companies are shown in the chart. Corporates with a “sound credit risk profile” are ones with a leverage ratio (measured by the ratio of debt to EBITDA) between zero and 5 and an interest coverage ratio (ICR) higher than 2. The other three types of companies all have a leverage ratio either above 5 or below zero (due to negative EBITDA). Among these, “leveraged distressed” corporates have an ICR lower than 1, “leveraged at risk” corporates have an ICR between 1 and 2, and “moderately leveraged” an ICR higher than 2. Debt data include the total debt reported on the liability

side of the balance sheet. See Annex B in Roulet (2024) for further details.

Source: LSEG, OECD calculations.

These developments raise potential financial stability risks, reflecting the growing exposures of various interconnected financial intermediaries. The higher financing costs and lower earnings of commercial property developers could raise banks' non-performing loans and generate losses for non-bank financial intermediaries. Significant losses at specialised commercial real estate investment trusts could spread to real estate investment funds, raising investor redemptions and potentially triggering downward price spirals from fire sales. Insurance companies' solvency ratios and pension funds' liquidity could also be adversely affected by losses, both directly from their commercial real estate loans and indirectly through their linkages with real estate funds.

Policy challenges remain in assessing and mitigating risks from commercial real estate exposures. Significant data gaps hinder accurate analysis of the exposures of many financial intermediaries. For instance, breakdowns of commercial real estate exposures by asset classes and type of collateral are often missing. Existing macroprudential tools in commercial real estate finance, such as capital buffers or loan-to-value ratios, are also primarily bank-based, with limited measures available to mitigate risks in non-banks. The use of these tools can also vary across jurisdictions.

Many policy tools to help monitor and mitigate financial stability risks from the commercial real estate sector need to be developed further, including:

- Cross-country agreement on a precise definition of commercial property assets and the development of common qualitative and quantitative indicators (ESRB, 2023a).
- Increased evaluation of the credit quality and loss-

provisioning of commercial real estate portfolios held by both banks and non-bank financial intermediaries (ECB, 2023; ESRB, 2023b; IMF, 2024), along with enhanced stress-testing of banks. Such tests should take account of indirect exposures to commercial real estate through the bank funding of non-banks.

- Improved assessment and mitigation of liquidity mismatches and leverage risks for institutional investors and real estate investment funds, including constraints on redemptions in the latter (FSB, 2023; IOSCO, 2024).
- Further work on borrower-based measures, especially for non-bank financial intermediaries, and enhanced international cooperation to help limit regulatory fragmentation. Such measures should include limits on excessive indebtedness and regulations to ensure solid credit quality and adequate repayment capacities.

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The rise of private credit markets: A threat to financial stability?

Category: Private sector, Uncategorized

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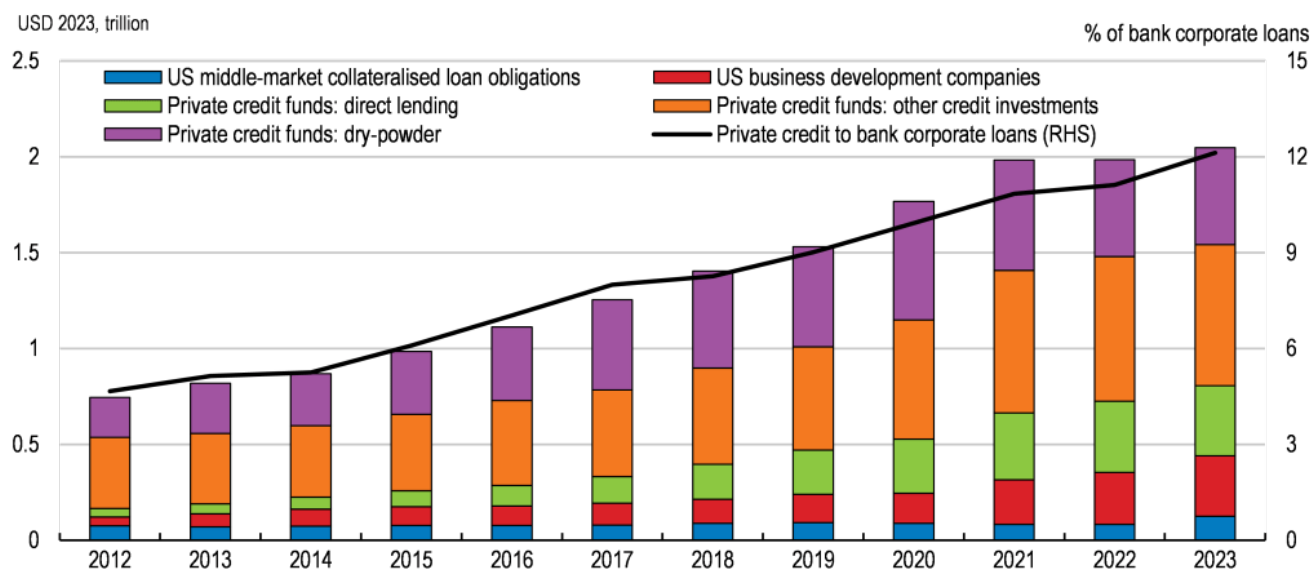
By Caroline Roulet.

Private credit has become an important source of financing

Private credit is a form of non-bank financing to firms, mainly through specialist funds that raise long-term capital from end-investors and offer long-term floating-rate loans to middle and smaller sized companies without access to capital markets or bank credit. End-investors such as pension funds and insurance companies value private credit for a number of reasons, including portfolio diversification, confidentiality, and potentially higher returns. Regulatory compliance costs could also be lower, although this varies by type of end-investor.

The latest OECD Economic Outlook documents the rapid expansion of this form of financing since the Global Financial Crisis and analyses the potential risks to financial stability. Private credit markets reached USD 2 trillion globally in 2023 (Figure 1). This was equivalent to 12% of bank loans to non-financial corporations, up from 5% in 2012. Private credit is very diverse but primarily US-focused, though is now also expanding rapidly in Europe and Asia.

Figure 1. Private credit continues to rise in advanced economies



Note: Business development companies (BDCs) are SEC-regulated, closed-end or publicly traded investment companies that must invest 70% of their assets in US companies valued under USD 250 million. Middle-market collateralised loan obligations (CLOs) are a segment of the US CLO market backed by senior secured loans to smaller companies that are originated in either public or private markets. Dry-powder is unallocated or unused capital maintained as cash reserves or liquid assets for future investment. Data are expressed in USD trillion adjusted by the 2023 US consumer price index and as a share of bank loans to non-financial corporations in advanced economies. See note of figure 1.25 in the December 2024 OECD Economic Outlook for further details.

Source: Houlihan Lokey; International Monetary Fund (IMF) Financial Soundness Indicators database; Pitchbook; and OECD calculations.

The expansion of private credit markets raises potential financial stability risks

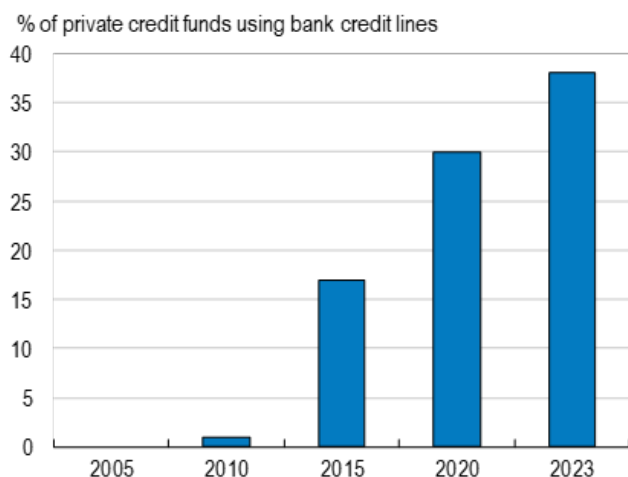
The growth in private credit has become a matter of interest for central banks and other regulators due to the relative lack of visibility of the market and the underlying risks, and the extent to which private credit funds are interconnected with other financial institutions, not least banks.

Losses by private credit providers could quickly spread to banks. Private credit funds rely increasingly on secured credit lines from banks, with these collateralised by private loans (Figure 2, Panel A). Private capital funds (such as private equity funds) have also become major investors in financial instruments that transfer risks from bank loan portfolios (so-called “credit risk transfers”). This generates risks for both private capital funds and banks if either credit quality deteriorates or if funds’ large end-investors are unable to provide the capital they have committed to.

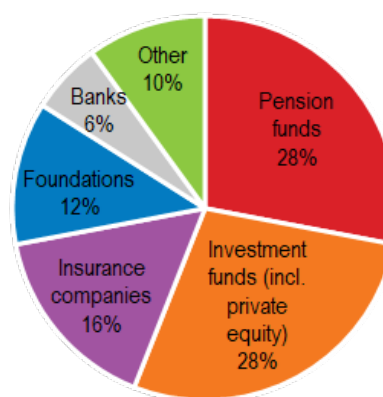
Private credit funds are also directly interconnected to private equity funds and institutional investors (Figure 2, Panel B). For instance, large private capital funds often manage both private equity and private credit portfolios. Also, private credit funds often provide credit to companies wholly or majority-owned by private equity funds. Consequently, vulnerabilities in one segment of the private financing industry will likely spill over to the other. Liquidity pressures could also arise for end-investors, including insurance companies and pension funds, if there are unexpected capital calls by private credit funds. Such risks are more likely due to the rising amount of committed but so far uninvested capital by end-investors (so-called “dry powder”), frequently held as cash reserves by private credit funds. In the United States, systemic risk warnings are increasing due to insurers’ private credit exposures (Fournier et al., 2024). In Europe, the difficulties of an Italian insurer (Eurovita) illustrate similar risks (AMF, 2024).

Figure 2. Interconnections between private credit funds and the financial system are growing

Panel A. Banks increasingly finance private credit funds



Panel B. Pension funds and insurers are major investors in private credit funds



Note: In Panel B, credit lines to private credit funds are not included in banks' investments, and data are as of June 2022. Source: MSCI (2023), Blackrock (2023), and OECD calculations.

More broadly, the lack of transparency in private markets is a concern. Multiple layers of leverage from borrowers to funds to end-investors are a potential source of financial instability, with risks of liquidity shortages triggering fire sales and simultaneous deleveraging. Although most private credit funds are unleveraged, some use derivatives for leverage (Federal Reserve, 2023). Some private credit funds also permit redemptions, which increases their liquidity risk.

The recent deterioration in credit quality is a further source of potential risk. A heavier debt service burden for private credit borrowers has led some to delay repayments by adding interest coupons to the loan principal. Refinancing risks are also raised, especially for the most fragile borrowers, because around 50% of the outstanding loans of US private credit funds are due to be reimbursed within three years (Cai and Haque, 2024). With defaults among highly leveraged non-financial corporations rising, there are risks that losses on private credit loans could rise sharply. Such loans are often to firms in economic sectors with low collateralisable or tangible assets and hence low recovery rates in the event of business failure.

Private loans are non-traded, which hinders proper valuation by investors and monitoring by regulators. Credit risk assessments are also uncertain in the absence of clear regulatory standards and could result in losses being underestimated. In the event of a severe shock, a rapid loss of confidence could trigger margin calls in derivatives used by private credit funds, adding further to liquidity pressures from redemptions, with risks that distressed funds default with losses for end-investors. Many liquidity management tools at private credit funds have yet to be fully tested in severe scenarios. While divestment and fire sale risks seem low at present, close monitoring is needed given significant data gaps about the sector and its often limited prudential or conduct oversight. Greater transparency in regulatory reporting would close data gaps and enable better assessment and management of risks by private credit funds and end-investors (EBA, EIOPA and ESMA, 2024; IMF, 2024). Regulatory assessments and stress-testing of end-investors should also take appropriate account of their exposures to other non-bank financial institutions (Acharya, Cetorelli and Tuckman, 2024).

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Yes, finance fuels income inequality

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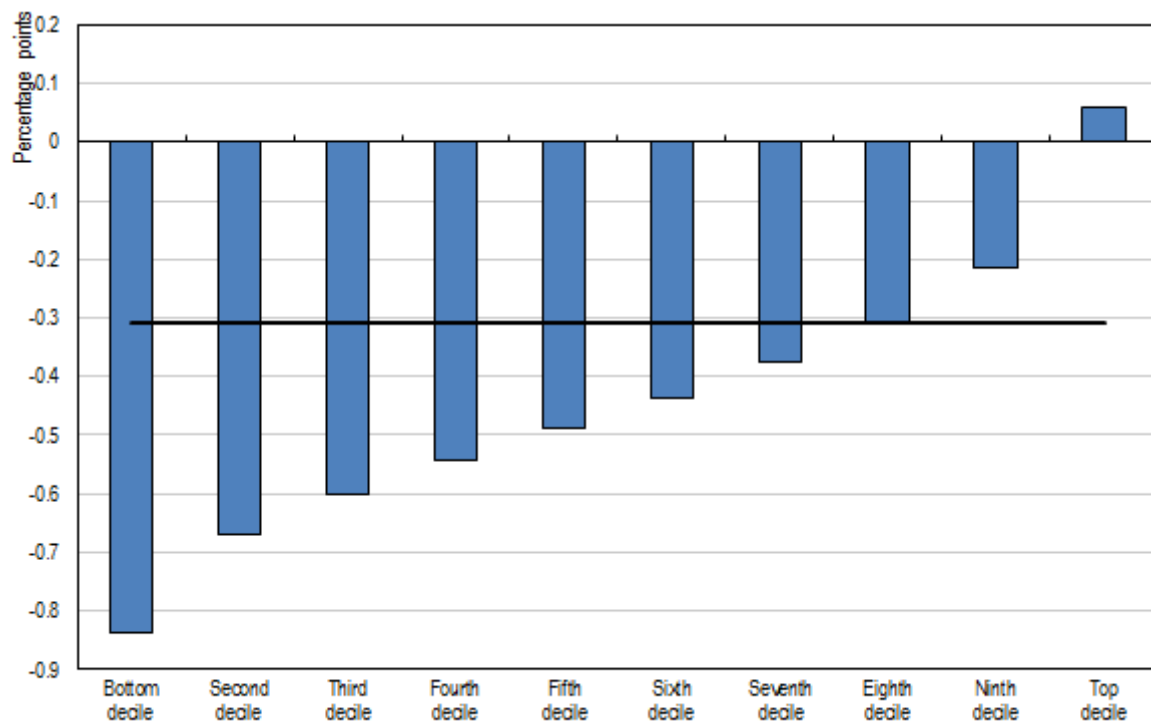
**by Boris Cournede,
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The Great Financial Crisis has prompted a lively debate, where the financial sector has been accused of not only triggering crises but also concentrating income in the hands of a few. The Occupy Wall Street movement in New York coined the slogan “we are the 99%”, that is to say the bottom 99% in the income distribution. The OECD in Paris has extensively probed the data to examine how finance influences the distribution of income.

The main conclusion is that, indeed, financial expansion exacerbates income inequality. Econometric investigations uncover that more finance, in the form of more bank credit or larger stock markets, goes hand in hand with higher income inequality across OECD economies (see Chart). Further expansion in bank credit from the levels observed in OECD countries is associated with slower household income growth, but the negative effects are particularly acute at the bottom of the distribution, while simulations suggest that the top 10% benefit. Stock market expansion is linked with stronger household income growth, but the benefits are concentrated at the top and the very bottom of the income distribution is simulated to lose out. These effects, which have been identified on average across OECD countries, might not apply at lower levels of development.

The effects of credit and stock market expansion vary a lot across income levels

A. Simulated effect of a 10% of GDP expansion of financial sector credit on household income growth



B. Simulated effect of a 10% of GDP expansion of stock market capitalisation on household income growth

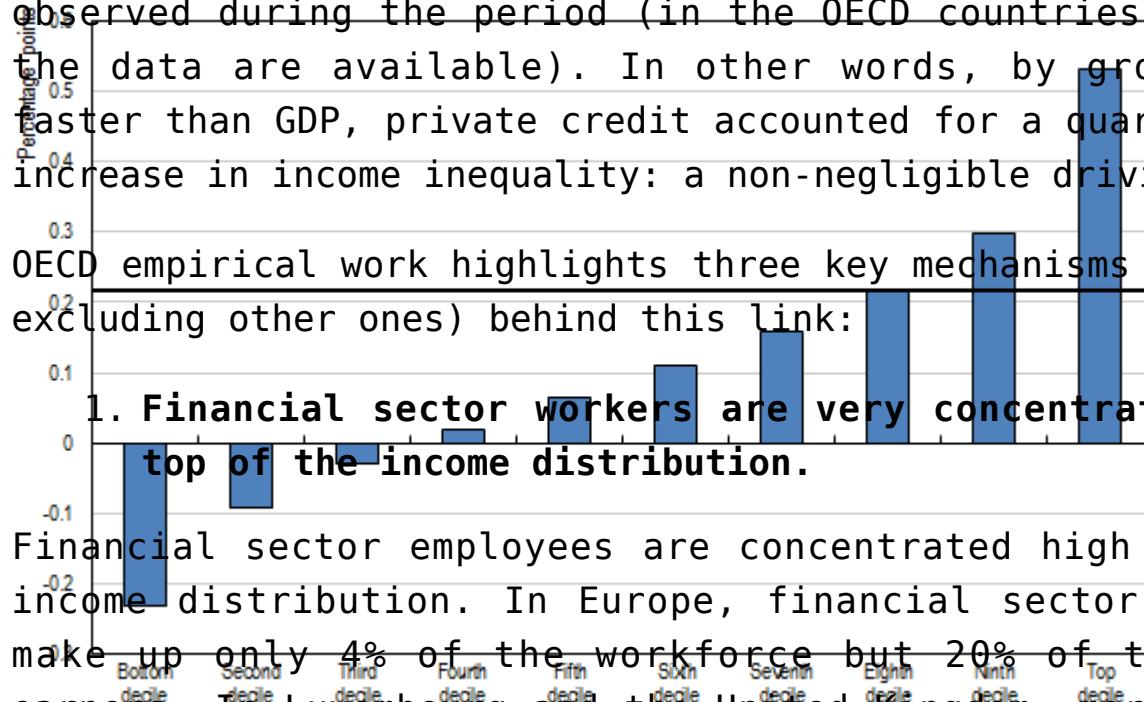
Note: Household income growth is household disposable income growth per capita. Stock market capitalisation is the value of all shares listed in a stock market. The horizontal line indicates the change in household income growth for the economy as a whole.

The estimates suggest the strong expansion of private credit over 1990-2010 contributed 0.8 Gini points to the 3.1 Gini-point widening of household disposable income inequality observed during the period (in the OECD countries for which the data are available). In other words, by growing much faster than GDP, private credit accounted for a quarter of the increase in income inequality: a non-negligible driving force.

OECD empirical work highlights three key mechanisms (while not excluding other ones) behind this link:

1. Financial sector workers are very concentrated at the top of the income distribution.

Financial sector employees are concentrated high up in the income distribution. In Europe, financial sector employees make up only 4% of the workforce but 20% of the top 1% earners. In Luxembourg and the United Kingdom, more than 30% of employees in the top 1% work for financial firms. The high



number of financial sector workers among top earners is justified as long as very high productivity underpins their earnings. However, detailed econometric investigations find that financial firms pay wages well above what employees with similar profiles earn in other sectors. Even worse, the premium is especially large for top earners.

2. High income earners can and do borrow more.

The distribution of credit is twice as unequal as the distribution of household income in euro area countries (where detailed, internationally comparable data are available). More than 45% of total household credit goes to the top 20% of the income distribution in Austria, Finland, France, Germany and Italy. Credit expansion fuels income inequality, because the well-off gain more than others from the investment opportunities that they can identify.

3. Much of the benefits of stock market expansion go to affluent households.

Stock holdings are disproportionately concentrated in the hands of high-income people. In the euro area, stock market wealth is four times more unequally distributed than household income. As a consequence, larger stock markets, which generate more dividends and capital gains, widen the income distribution.

As a result, more finance means more income inequality.

Find out more:

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