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Will banks grasp the nettle and take back control of failing properties?

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Banks are more likely to act as the year goes on

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There's a little bit of Mr Micawber in all of us. The Charles Dickens character, famed for his optimistic belief that "something will turn up", would certainly recognise the approach of many lenders to recent market challenges. "Extend and pretend" has been the modus operandi for distressed loans, with fingers crossed that the situation improves and loan-to-value (LTV) ratios return to more palatable levels.

If eurozone lenders thought they could navigate current market turbulence with such tactics, the European Central Bank (ECB) is making them reconsider. At the start of February, the ECB signalled to banks that they may face higher capital requirements if they do not mitigate their risk from commercial real estate exposure, with new buffers likely to be effective from the end of the year.

Attention has focused on Germany – understandable, given the size of loan books (an aggregate of nearly €300bn) and the scale of value drops being seen there. But lenders in France, Italy and the Netherlands will also be looking nervously over their shoulders.

With transactional markets stagnant, and sales in distressed sectors often simply crystalising losses, banks have started to place assets into receivership, taking the hit and appointing asset managers to realise as much value as possible. The question is: will UK banks follow suit?

Holding on

The answer is a complicated one, not least due to the differences between the UK and the Continent on market conditions, future expectations and regulatory pressure. Unlike the ECB, the Bank of England has yet to make its feelings known – albeit commercial real estate exposure is likely to be high on the agenda the next time capital requirements are hammered out.

Economic and market dynamics differ, too. The UK may have recently joined Germany in recession, but sentiment suggests the downturn here will be shorter and shallower. There is an argument to be made that the pain of value drops hit the UK earlier – particularly in the secondary retail and office sectors – and as such the falls now are not so dramatic.

> *“Like the proverbial boiling frog, valuations have not fallen at a steep enough rate to prompt action from lenders”*

The combined effect of prevailing conditions has been a higher willingness on the part of UK banks to show forbearance in the hope of better times ahead. Like the proverbial boiling frog, valuations have not fallen at a steep enough rate to prompt action from lenders, but that doesn’t mean the issues have been overcome.

The expectation is for a recovery that will cure LTV breaches, but there is no certainty it will come. Price corrections are now well advanced, but interest rates remain high – and seem likely to stay elevated for longer than anticipated – with financing remaining challenging. Optimists are looking for the bottom of the market – pessimists think that, for some assets, the decline is terminal.

Grasping the nettle

This is far from a uniform problem. Amid the challenges, there are plenty of sectors and locations that are doing just fine – genuinely prime offices, industrial and residential-led assets are all ticking along nicely. It is secondary office and retail that are causing the biggest headaches, and for some the bottom of the market could be a way off yet.

Both have been impacted by structural shifts in how these assets are used – retail first over the past decade as online shopping took its toll, and offices more recently as remote working has surged. There is optimism in some quarters that retail investment has turned a corner, but the market is yet to be properly tested. The jury is still very much out on just how much office space will be needed in the future.

> *“A threshold will be reached that will prompt the hard decisions to be made”*

For many assets, the point at which lenders take control is fast approaching. They know that the status quo cannot continue forever, and that even if values bottom out, unless there is material uplift, then action will still need to be taken. The outlook may not be catastrophic, but a sober assessment of what the year has in store will prompt many to pursue a more activist strategy.

Elevated interest rates, structural issues and a sluggish economy are not the conditions for surging values and improving LTV ratios.

Ultimately, a threshold will be reached that will prompt the hard decisions to be made. Lenders have been hoping for the best, but are aware that their plans will have to change.

Taking the writedown now – bringing in expert asset management teams and working to maximise loan recovery – will look increasingly attractive as the year goes on. So, will 2024 be the year that UK banks push the button? It’s looking ever more likely. Time to grasp the nettle.