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Central Bank of Ireland
Financial Stability Review 2024:I

Special Feature
Commercial Real Estate: A Macro-Financial Assessment

June 2024

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Introduction

Segments of the Commercial Real Estate (CRE) market globally are in the midst of a sharp downturn. The Irish CRE market is no different, with valuations down an estimated 27 per cent since late 2019. This *FSR Special Feature* presents the outcome of an in-depth assessment undertaken by the Central Bank during the first half of 2024 that focussed on the domestic financial stability implications of the ongoing adjustment in the CRE market.

The nature of financing of Irish CRE has changed markedly since the global financial crisis, with a smaller role for domestic banks and a greater role for non-bank and international sources of capital. The Central Bank's judgement is that the domestic banking system is sufficiently resilient to absorb – rather than amplify – this CRE downturn. Non-bank sources of financing in the CRE market, such as Irish property funds and local non-bank lenders, have not exhibited signs of amplifying the shock to date. But these segments are untested through a full financial cycle and, for non-bank lenders with limited regulatory touchpoints, the Central Bank has less visibility over potential underlying financial vulnerabilities.

Looking ahead, there remains significant uncertainty over the market outlook, stemming particularly from structural developments in the office sector and the risk that financial conditions could remain tighter for longer than currently expected. The Central Bank will continue to monitor the CRE market closely and engage with regulated financial institutions to ensure they identify and manage CRE-related risks actively.

When considering the current CRE downturn, the key question for domestic financial stability is whether it can be absorbed – rather than amplified – by the financial system. The sector has been facing a series of fundamental shocks, which include the rise in interest rates in response to high inflation, as well as structural changes affecting demand for space in segments of the market following the pandemic (such as the rise in homeworking and the increase in e-commerce). There is a strong global, correlated dimension to this shock, which has become an areas of focus for many policy institutions.[1] From a financial stability perspective, the implication of shocks to CRE depends on the degree of financial vulnerabilities built up by key agents in the sector, and the systemic importance of the assets or agents in question. An adjustment can be characterised as *orderly* if market participants can absorb an adverse shock, without knock-on implications for the rest of the financial sector or the broader economy.

Disorderly adjustments generally involve financial amplification mechanisms and the propagation of the shock beyond the asset class in question. A more *disorderly* outcome would involve prices and activity falling more than would be suggested by the fundamental economic shock. This can happen in light of financial vulnerabilities, including high levels of debt or liquidity mismatches, which could trigger fire sale dynamics. For the disorderly shock to pose broader domestic financial stability risks, there must be particular channels that impair the balance sheets of key local actors

[1] The sharp adjustment in global CRE markets in recent years and high-profile bankruptcies of CRE firms (e.g., Signa) has prompted many authorities with a financial stability and/or prudential mandate to focus on risks from this sector. In Europe, the ESRB issued a recommendation on vulnerabilities in the commercial real estate sector in the European Economic Area in 2023, which requests that EU and national authorities enhance the monitoring of systemic risks stemming from the CRE sector, as a means to identify potential vulnerabilities and assess potential responses.

and lead to negative spill-overs for the domestic economy (see chapter 3, IMF, 2021). An example would be the case of key lenders experiencing losses that compromise their capital adequacy, leading to the curtailing of credit supply to the broader economy (the *bank solvency channel)*, or the shock impairing balance sheets of non-CRE businesses and affecting their ability to borrow or invest (the *collateral channel*).

The current CRE downturn is not homogeneous and differs significantly in its severity across key market segments. While office and retail valuations have suffered due to the adoption of remote work and increases in e-commerce brought about during, or accelerated by, the pandemic, two other key market segments, residential and industrial, have been much less negatively affected. Each of these four broad sectors is similarly important on domestic bank balance sheets, although offices are more prominent within the portfolios of Irish property funds.

Activity in the Irish CRE market is widely diversified across the origin of investors, and types of entity involved in financing. The current diversified nature of financing of CRE in Ireland is in sharp contrast to the concentration in financing in the run-up to the global financial crisis (GFC). Prior to 2008, concentration of CRE exposures at domestic banks, in turn providing debt financing to domestic investors, led to large macro-financial spill-overs from the CRE market shock during the GFC. Lenders' capital ratios were diminished by loan losses, while insolvencies of local developers and investors had wider impact due to the domestic nature of their balance sheets. By contrast, in 2024, the CRE market relies much more heavily on international sources of finance. This includes financing intermediated by Irish-authorised property funds, which hold close to €30 billion of assets, much of which is financed with debt and equity from abroad. More broadly, market intelligence and transaction data suggest that a meaningful proportion of CRE assets are likely held by, or funded by, overseas entities on a cross-border basis. While more international investor participation, which has been a feature of global CRE markets for many years, can increase risk associated with capital inflows and a more amplified asset price cycle, it also mitigates domestic financial stability risks through risk-sharing mechanisms when shocks hit.

Diversification brings benefits, but also interconnectedness that requires analysis, monitoring and bridging of data gaps. The range of market participants and finance providers in the Irish CRE market in recent years poses challenges in terms of understanding the full range of ultimate financial connections and exposures to the market. CRE deals can be multi-party in nature, involving a third-party broker, bespoke financial vehicle or global unregulated fund, in addition to traditional bank and non-bank financial intermediaries (i.e., specialist lenders, insurance corporations, and pension or regulated investment funds). The profile of market participants can also change in response to macro-financial developments. While some investors may take a long-term view, others, driven by short-term returns, may enter and exit more frequently. Such mobile international capital can entail benefits, but brings volatility and risk that must be understood when assessing market dynamics. Increased monitoring requirements have led to enhanced data collections, procurement of transaction level data by the Central Bank and international coordination on bridging CRE data gaps.[2]

[2] In 2016 the ESRB issued a recommendation to member states on closing real estate data gaps (amended in 2019), which aims to harmonise the definitions used and to identify a common set of indicators for a framework to monitor emerging risks and vulnerabilities in Europe's residential and commercial real estate markets.

Domestic banks now play a less important role in the financing of CRE activity in Ireland than in the past, mitigating the extent of domestic financial stability risks from CRE. Domestic banks' lending for Irish CRE is approximately €12 billion. As a share of all domestic bank lending, CRE has fallen from above 30 per cent before the GFC, to 17 per cent in 2015, to close to one-tenth in 2023.[3] Domestic real estate businesses now rely on a mix of lending from banks and non-bank lenders (NBLs), and can also source financing directly from international lenders and capital markets. Recent estimates suggest that loans from Irish-domiciled NBLs may now account for 35 per cent of borrowing by Irish-resident real estate businesses (Lambert, Mahony and McGeever, 2024), and closer to 50 per cent of new lending for real estate SME businesses (see FSR 2024:I). The reduction of the importance of domestic banks is critical to understanding how the CRE market adjustment might impact domestic lending and potential spill-overs to the real economy. In addition to direct lending to real estate businesses and investors, systemically important banks' portfolios also have loan exposures to entities such as Irish property funds, opening up a source of interconnection between two regulated sectors with CRE exposures.

This *FSR Special Feature* first presents the estimated size and composition of the stock of Irish commercial property to benchmark financial sector exposures, and then examines the wide range of investors operating in the market, using a sample of recent transactions. Second, the scale, nature and factors contributing to the current downturn in Ireland are analysed in a global context. Thirdly, the current financial resilience of domestic banks, Irish property funds and non-bank lenders is assessed, followed by conclusions.

Commercial property in Ireland

Understanding the size and composition of the commercial property market provides important context for the financial stability assessment of developments in the sector. In this section, the Central Bank highlights the findings of in-depth analysis estimating the total value of the stock of commercial properties in Ireland using novel granular data from Tailte Éireann. New insights from market data on CRE transactions are then presented, highlighting the diversity, in entity type and geographic origin, of key participants in the CRE market in Ireland.

The Central Bank estimates the total value of Irish commercial properties to be around €144 billion. There is uncertainty over the total value of Irish commercial properties in Ireland and previous work has highlighted data gaps on the CRE market. A wide range of data sources have been deployed to better estimate the size of the CRE market in Ireland. Today, the Central Bank publishes an accompanying *Financial Stability Note* (Shaikh, 2024) that provides an estimate for the market valuation of all commercial properties in Ireland as of 2024Q1. The method uses administratively-reported estimates of the rental value of commercial property in Ireland from Tailte Éireann, combined with publicly available information on yields across market segments.

[3] See Lyons, Nevin and Shaw (2019) for a long-term perspective on real estate concentration in the Irish banking system.

Under this method, the Central Bank estimates that the stock of commercial property in Ireland is currently valued at around €144 billion.[4]

When looking at the total stock of commercial properties in Ireland, the office and retail segments are smaller than the industrial segment. The granular nature of the data allows segmentation of the market into key components. Despite the importance of office and retail markets in the income-generating segment of the market, Shaikh (2024) highlights that the stock of industrial properties is actually larger than both, in terms of building footprint and market value (Chart 1).The data also allow geographic segmentation of parts of the CRE market. For illustration, industrial buildings in Dublin are valued at €22.4 billion, and at €28.5 billion in the rest of the country. In Dublin however, the office market is particularly important, valued at €25.6 billion, more than three times as valuable as the office stock in the rest of the country, and valued at close to one sixth of the stock of Irish commercial property (Chart 2).

Some buildings are owned and operated by trading businesses, while others are owned by investors to generate income. Within the entire stock of €144 billion of commercial properties in Ireland, a subset of the stock – those properties that are rented or leased, generating income for property investors – is particularly relevant for financial stability purposes. This importance derives from the fact that income-producing CRE properties are those most likely to be frequently transacted, to be financed with debt, and to drive asset price cycles. Still, the owner-occupier set of properties is also important from a macro-financial perspective, to the extent that falls in asset valuations feed through to the net worth of companies, with implications for their willingness or ability to invest and grow. Data are not available on the precise split between owner-occupier and rented commercial property in Ireland, so an estimate of the income-generating CRE market can only be arrived at by applying assumptions and scenarios.

Previous analysis suggests the size of the professionally managed, portfolio-investable CRE market may have reached €58 billion by end-2022. Previous analysis by Central Bank researchers in 2019 highlighted different estimates available for estimating the size of the professionally managed, portfolio-investable CRE market in Ireland at the time.[5] This represents the segment of the market that is most likely to be included in portfolios of large, institutional investors. The *invested* CRE market as defined by Cushman and Wakefield (CW) was estimated at €48 billion in 2016. Applying growth rates in market size estimates from MSCI suggests the professionally managed, portfolio-investable CRE market, by the broader CW definition, may have been €58

[4] Rental estimates at the property level are provided to local authorities for the purpose of calculating commercial rates. This is the information source underlying the Tailte Éireann data. Industrial, office, retail and other commercial properties are all captured in the data. For the residential component of the CRE market, the research sources information on asset holdings from the MSCI Real Capital Analytics database, and measures only those residential properties owned by institutional investors for the purpose of income generation. Further methodological details are provided in Shaikh (2024).

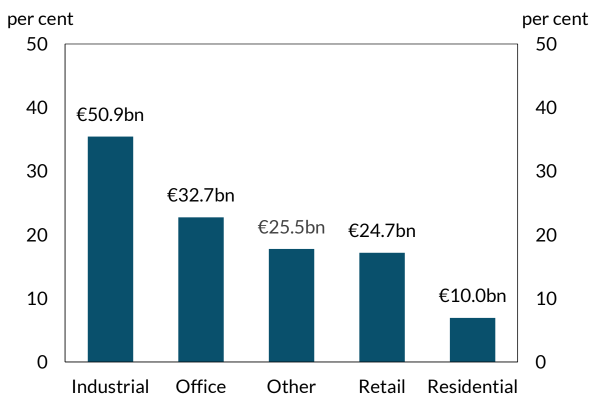
[5] The definition of CRE used in this study was aligned to the one contained in the ESRB's recommendation on closing real estate data gaps (ESRB/2016/14). The recommendation refers to, "income-producing real estate, either existing or under development, including rental housing or real estate used by the owners of the property for conducting their business, purpose or activity, either existing or under construction, that is not qualified as RRE property". In this way, traditional CRE sectors such as office, retail and industrial/logistics are covered, but so too is the institutionally owned private rental sector (PRS) which has become a significant component of the Irish property market in recent years.

billion at end-2022. This definition, though, is likely to miss smaller properties that may not be included in institutional investors' portfolios.

A broad range of Irish-based financial entities have exposures to the CRE market. The Central Bank estimates that the value of commercial properties connected to entities under Central Bank regulation and supervision comprise around €55 billion-€60 billion. This includes €29 billion held by Irish property funds, an estimated €20 billion-€25 billion of commercial property collateralised on domestic banks' €12 billion of domestic CRE loans, €3 billion of property held by insurance companies, and €1.3 billion held by REITs.[6] In addition, information from the Central Credit Register (CCR), outlined in detail in the Resilience section below, suggests domestic non-bank lenders may have an estimated €6.5 billion of lending to real estate businesses. Based on an estimated LTV of 50 to 60 per cent, this would equate to these lenders providing debt financing for property holdings of around €11 billion-€13 billion.

Chart 1: Within the stock of commercial property, industrial is particularly large

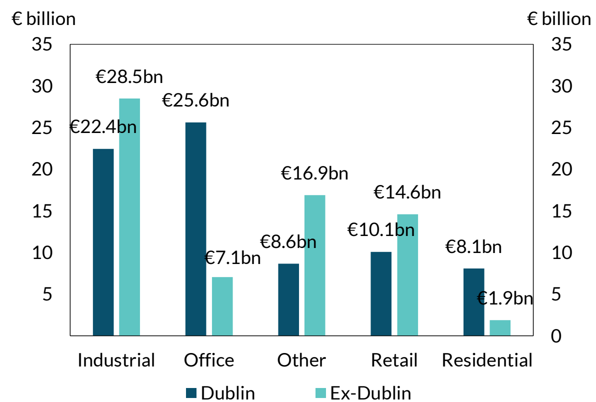
Estimates of market valuation of key commercial property sectors



Source: Tailte Éireann and MSCI Real Capital Analytics.
Notes: Based on 2024 yields. *Other* includes properties such as hotels, and licensed premises such as Cinemas, and Pubs, that are valued according the trading value of the business. *Residential* refers to institutional investor holdings of residential property. See Shaikh (2024) for more details.

Chart 2: Geographically, Dublin is particularly important in the office market

Market valuation of commercial property: sector and Dublin/non-Dublin split



Source: Tailte Éireann and MSCI Real Capital Analytics.
Notes: *Residential* refers to institutional investor holdings of residential property. See Shaikh (2024) for more details.

Granular data on individual CRE transactions confirm the globalised, diversified investor pool in recent CRE activity. An analysis of recent commercial property transactions which appear in MSCI's Real Capital Analytics (RCA) database[7] indicates that the Irish investment market is comprised of a range of company types, established under a variety of legal structures from a range of countries, highlighting the complexity of the asset class. Overall, a diverse set of entities in the asset management sector have dominated recent transactions, but the presence of developers, high net worth private investors, government and corporations highlight the cross-sectoral nature of this market and potential transmission channels across financial sectors and the

[6] The nature of the regulation / supervision applicable to these entities varies, for example, REITs are indirectly subject to regulation which applies to their Alternative Investment Fund Managers (AIFMs) but are not directly authorised or supervised by the Central Bank.
[7] Private companies have moved to address the lack of publicly available data on the CRE market globally given strong investor demand for such products. MSCI products are widely used to analyse this very heterogeneous and opaque market. RCA provides very granular insights on investor and lender profiles.

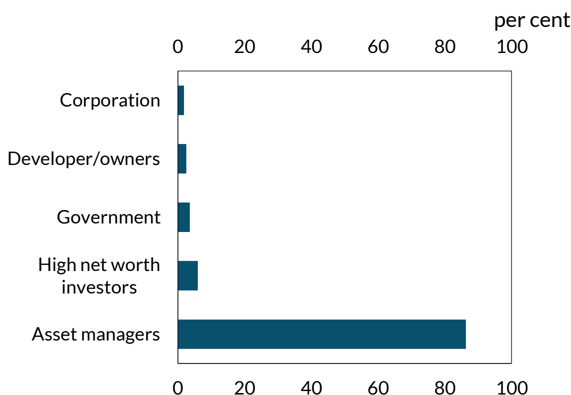
real economy (Chart 3). Within the asset management sector, there are a variety of entities, including domestic REITs and Irish property funds, as well as global institutional investors, that may invest either on a cross-border basis or by setting up entities domestically.

Transaction flows have been concentrated among a small number of large investors in recent years. Combined, the top 10 investors in Irish CRE for each of 2022 and 2023 accounted for approximately 70 per cent of the total investment that occurred across the two years. A breakdown of the investors involved in these deals, by country of origin, suggests North American entities and those headquartered in mainland Europe have been particularly active in the Irish CRE market (Chart 4). Looking at the initial year of engagement in the domestic CRE market, many of the top investors in 2022 and 2023 appear to be recent arrivals. Specifically, of the 20 investors analysed, 6 have had their first investment here since 2021[8], another in 2020, and one more acquired Irish assets for the first time in 2019.

The Central Bank will continue to deepen its analysis of the CRE market as a whole combining these new transaction level data with regulatory and credit registry data. Deeper insights from these investment transaction data will complement the Central Bank's existing financial stability and prudential assessments which draw on exposures data from regulated entities. As this is a first counterparty database, further integration with other granular datasets may, be required, where deals are conducted by an intermediary on behalf of a final investor to uncover the ultimate risk holder on CRE transactions.

Chart 3: Private market sources of finance have dominated investment in the last two years

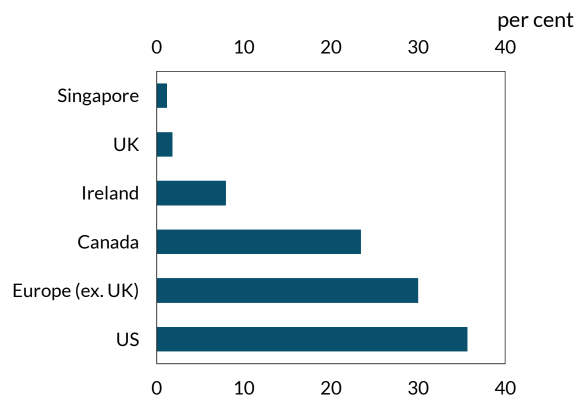
Breakdown of the combined top 10 Irish CRE investors from each of 2022 and 2023 by entity type



Source: MSCI RCA and Central Bank calculations.
Notes: Figures based on the deals of the top 10 Irish CRE investors during each of 2022 and 2023 as listed by MSCI RCA. Cumulatively, these deals have a value of €5.5 billion. MSCI RCA categorise these investors into the following entity types; investment managers, equity funds, high net worth private investors, open funds, public REITs, private REITs, developer/owner, government and corporations. Some of these categories (investment managers, open funds, equity funds, private REITs and public REITs) have been merged into the "asset managers" category, for the purposes of this chart.

Chart 4: North American and European firms have dominated Irish CRE investment in the last two years

Breakdown of the combined top 10 Irish CRE investors from each of 2022 and 2023 by geographic origin



Source: MSCI RCA and Central Bank calculations.
Notes: Figures based on the deals of the top 10 Irish CRE investors during each of 2022 and 2023 as listed by MSCI RCA. Cumulatively, these deals have a value of €5.5 billion. Geographic location based on headquarters. Europe (ex. UK) firms are located in France, Spain, Germany, Belgium and the Netherlands.

[8] Of these 6 investors, one had their initial engagement with the Irish CRE market in 2021, one in 2022, with the remainder acquiring Irish CRE assets for the first time in 2023.

CRE market conditions

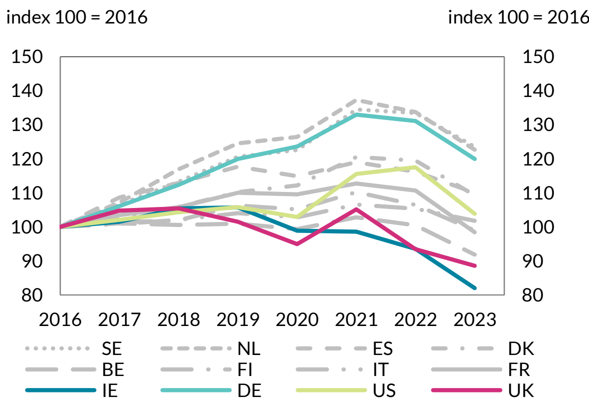
The evolution of rental and capital values

Irish CRE prices have declined sharply since 2020. Irish CRE capital values grew rapidly in the early phase of the recovery from the GFC, driven by an influx of global capital responding to attractive yields and domestic bank deleveraging, with growth rates peaking in 2014. Prices have been falling since the pandemic shock began in 2020 but the decline has been sharper since the increase in global interest rates in 2022. Latest figures suggest a decline of almost 27 per cent since the pre-COVID peak (2019Q3)[9], with a decline of 13.1 per cent in 2023 alone. Like in many CRE markets globally, the significant fall in the volume of transactions has limited price discovery in the market, which adds to valuation uncertainty.

The Irish market is being affected by a correlated global shock, particularly in the office sector. Comparing the CRE market in its totality, Ireland appears to have experienced a sharper cumulative decline than in many other countries (Chart 5). However, this is explained in part by the office market being a larger component of the total CRE market index in Ireland than in other countries.[10] Focussing on offices alone, the Irish, US, UK and Canadian markets appear to have followed a common global cycle since 2016, indicative of the importance of common factors and a deep, globalised pool of investment capital in the CRE office market (Chart 6). Capital values in many global and Irish retail markets also contracted significantly during the pandemic and in response to higher interest rates from 2022. More recently, prices have continued to fall significantly in the office sector, while the rate of decline in retail market has been lower.[11]

Chart 5: CRE markets globally are in a downturn

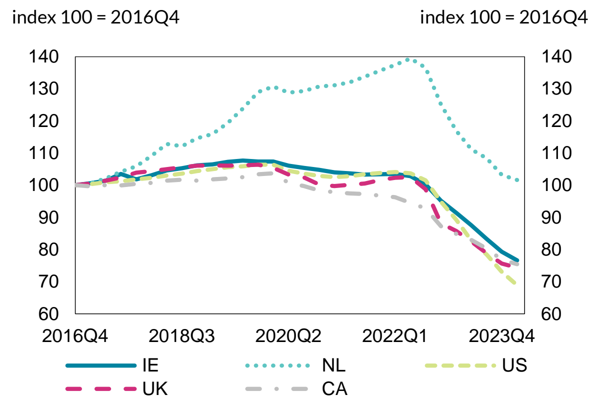
Cross-country comparisons of overall CRE capital value indices



Source: MSCI.
Notes: Last observation 2023.

Chart 6: A number of global office markets are facing a highly-correlated demand shock

Cross-country comparisons of office sector capital value indices



Source: MSCI.
Notes: Last observation 2024Q1.

[9] Despite the strong growth rates between 2014 and 2016, the Irish CRE market's capital value index pre-pandemic peak of 2019Q3 was still about 40 per cent below the 2007 peak level.
[10] For instance, analysis of sectoral weightings across a selection of countries show offices account for 66 per cent of the capital value weighting for the Irish index compared with a weighting of 23, 21, 28, 29 and 42 per cent for the UK, US, Canadian, New Zealand and Australian indices, respectively.
[11] As at 2024Q1, Irish office capital values fell by 16.3 per cent year-on-year compared with an annual decline of 8.3 per cent in the retail market.

Headline aggregate rents have remained relatively stable, despite the pandemic-related shock to demand and higher interest rates. Rents in the Irish market have remained broadly steady in recent years, supported by domestic economic resilience and a strong labour market. At sector level, however, there has been some variation. Rent and price growth has been strong and positive in the industrial segment, another legacy of pandemic-related changes to demand for warehouse space, for example. Within the office and retail markets, however, there are particular market segments which have experienced comparatively larger falls in rents, e.g. some of the major city centre shopping districts, provincial retail markets and to a lesser extent Dublin 4 offices (Table: 1). Market intelligence also indicate that, while headline rates have been slow to adjust, certain terms and conditions of rental agreements have been adjusting more favourably towards tenants, an alternate method of adjustment to higher vacancy rates.

Market rents adjust slowly, with long leases meaning new agreements are negotiated only gradually. Engagement with market experts indicates that the slow adjustment in headline rents to the structural shock of the pandemic relates partly to the structure of office rental leases. Recent analysis by the Central Bank of the maturity profile of leased Dublin office units, using data from the PSRA's Commercial Leases Register[12], estimates an average lease length, at initiation, of around 7.5 years.[13] The analysis also suggests that rental contracts are typically agreed for multiples of 5 years, with 10 year agreements covering almost 30 per cent of the leased space, and 20, 15, 5 and 25 year contracts covering 15, 12, 9 and 8 per cent of the remaining space considered, respectively. With only a portion of the office stock up for renegotiation in a given year, and ongoing uncertainty for many employers about their post-pandemic "steady state" need for office space, there remains considerable uncertainty around the path for rents and their ultimate adjustment to the substantial shock to office demand since 2020.

Table: 1: Sectoral performance since 2019 varies widely, with retail having suffered most

Changes in Irish CRE subsector capital values and rents from pre-COVID levels

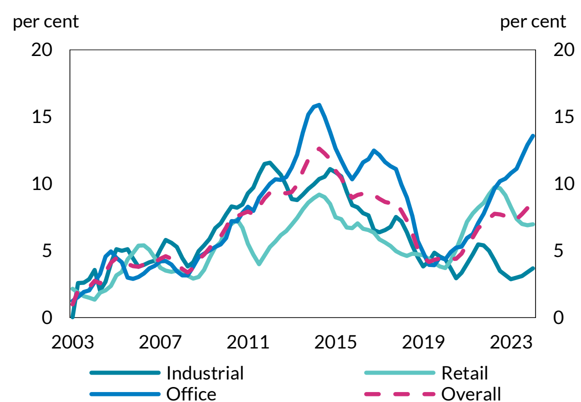
per cent change since COVID-19

Sector	Capital values	Rents
All	-26.4	-0.2
Retail	-37.0	-8.6
Office	-28.7	-2.0
Industrial	18.7	31.6
Retail - Henry/MaryStreet	-54.0	-27.5
Retail - Grafton Street	-47.7	-19.2
Retail - Provincial	-44.7	-25.5
Office - Dublin 4	-38.3	-7.2
Office - Dublin 1 3 & 7	-32.8	-0.5
Office - Dublin 2	-27.0	-2.4
Industrial - South West Dublin	17.2	33.7

Source: MSCI.
Notes: Table presents percentage changes in MSCI capital value and rent indices between 2019Q4 and 2024Q1.

Chart 7: The office sector vacancy rate continues to increase, while others have been easing

Irish CRE vacancy rates: overall and by sector



Source: MSCI.
Notes: Latest observation 2024Q1.

[12] The PSRA's Commercial Leases Register has been collecting information with respect to all commercial leases entered into since 2010, and contains information on the date of the lease, the property type, the location, average annual rent paid and the length of lease.
[13] Larger properties appear to have a longer lease length. When weighting leases by the volume of space occupied, the average lease is calculated at 12 years.

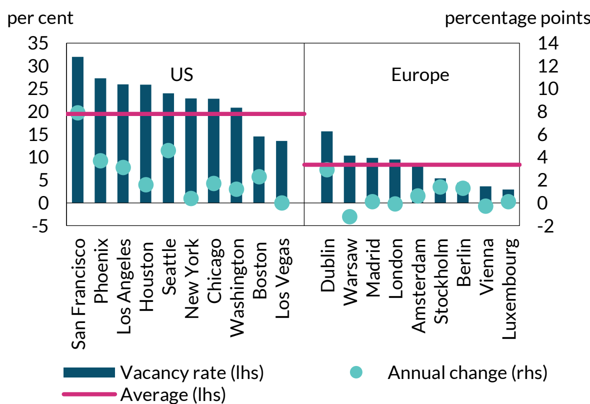
The shock to office rental fundamentals: developments in the vacancy rate

Vacancy rates, a key indicator of imbalances between the supply and demand of office space, have risen sharply in Ireland and globally since 2020. Vacancy rates rise when the supply of space is outstripping the demand for that space. In Ireland, the office market currently has a relatively high and growing vacancy rate signalling weak occupier demand relative to supply (Chart 7). Rising aggregate vacancy rates will ultimately impact future rents in a sector as leases expire. Lower projected income returns in turn have direct implications for the valuation of those assets, while uncertainty around the future income stream can affect the risk premium that investors demand to hold an asset. The combination of weakening rental income and the knock-on implications for asset values, means the full extent of the impact of this shock on office investors and their capacity to service financing is still unfolding.

The shock to fundamentals has been particularly sharp in the US office market, but less severe in Europe. Market commentary on CRE globally is heavily influenced by developments in the US market. The shock in the US appears particularly severe, with a number of the major US cities under study having a higher vacancy rate than Europe in late 2023, as well as a larger increase in vacancy rates (Chart 8). It is difficult to pinpoint the precise reason for this differential in vacancy rates on either side of the Atlantic, but this context is important when interpreting signals from developments in the US system.

Chart 8: Dublin office vacancy rate is high relative to elsewhere in Europe, but lower than in many US cities

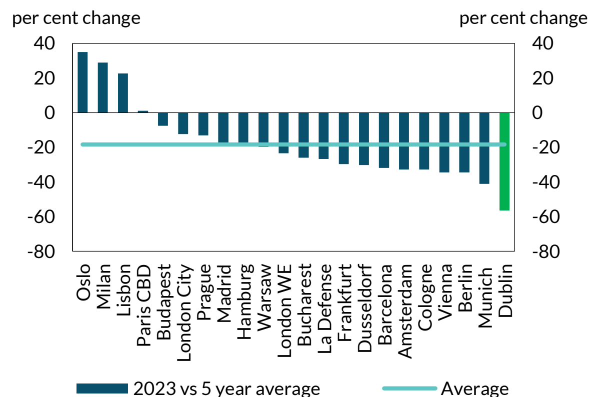
Office market vacancy rates in select European and US cities



Source: European data from Savills (European office outlook - Feb 2024) and US data from Cushman & Wakefield (US national market beat - office 2024Q1).
Notes: Data as at 2023Q4. Average figures refer to a wider sample of European and US cities.

Chart 9: The Dublin office market has had the sharpest fall-off in take-up of space recently

European office take-up: % change in 2023 level vs pre-COVID 5-year average



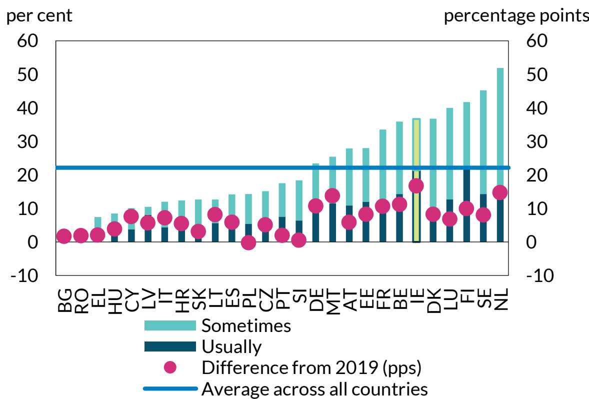
Source: Savills (European office outlook - Feb 2024).
Notes: Data are a comparison between the volume of 2023 office take-up and pre-COVID 5-year average annual lettings.

The Dublin office market has experienced one of the most adverse shocks to fundamental demand in Europe. Vacancy rates have risen more in the Dublin office market than elsewhere in a sample of European capitals. Office take-up also fell by more in Dublin than in many of the other European cities studied (Chart 9). One factor driving this larger shock to fundamentals relates to the importance of certain international technology companies, which grew rapidly before and during

the pandemic in response to higher demand for tech-related products and services. These companies have in many cases subsequently downsized when consumption patterns shifted as pandemic restrictions were removed. Indeed, letting activity by this cohort of occupiers has fallen substantially in recent years, from around 60 per cent of total annual Dublin office take-up in 2019 to about 20 per cent in 2023.[14] Another factor likely relates to a particularly pronounced shift towards remote working in Ireland. According to the latest Eurostat figures (covering 2023), Ireland has one of the largest cohorts of its workforce working from home "usually" (21.4 per cent) and has experienced the largest increase (16.4 percentage points) of any EU country in the share of employees who work from home "usually" or "sometimes" since the pandemic (Chart 10). Uncertainty around the long-term nature of remote working, and office demand more broadly, will continue to weigh on the outlook for rents and valuations in the Dublin office market.

Chart 10: Remote working has grown more in Ireland since the pandemic than almost anywhere in Europe

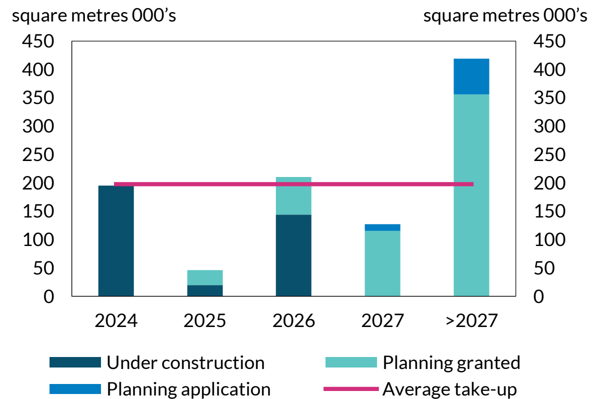
Employed persons working from home as a percentage of total employment



Source: Eurostat.
Notes: Latest observation 2023.

Chart 11: The office supply pipeline is large, but suppliers are now staggering delivery

Dublin office space pipeline



Source: CBRE Research.
Notes: Latest observation 2023Q4. Data refer to Dublin office space at various stages of the delivery pipeline - i.e. under construction, grants of planning permission and applications for planning permission.

The outlook for market prices

The outlook for Irish CRE prices is highly uncertain, driven by the interaction of the global financial cycle and local fundamentals. Since late 2022, market transaction volumes have been very thin, limiting price discovery and adding to uncertainty about true underlying property values. The future trajectory for prices will depend on a variety of factors. Globally, the path for interest rates and financial conditions in the US and Europe will drive investor demand and risk appetite given the role of international investors in the market. Locally, the continued fallout of post-pandemic demand for office and retail space relative to supply levels, the trajectory of the Irish economy, and the risks of financial amplification through local balance sheets, will all play an important role.

The domestic economy continues to grow, which should support rental incomes of CRE investors on existing leases. The latest Central Bank Quarterly Bulletin forecasts continued but moderating growth within the domestic economy and labour market, which should support resident firms' ability to pay rents and maintain CRE investor returns. Any plans for corporate investment or

[14] See Bloomberg's A different kind of property crash hits Dublin as big tech cuts for more on this Lisney data.

expansion could – everything else equal – translate into higher demand for office, retail or warehouse space highlighting the importance of continued corporate health for the CRE sector. As the Irish private sector is made up of both internationally active and indigenous firms, the current fragility around the global growth outlook and trading conditions, given geopolitical tensions in first half of 2024, create some uncertainty around demand from this sector. The office market outlook remains particularly uncertain, given the reliance of the Dublin market on a concentrated, narrow set of technology and finance sector businesses, leaving the market exposed to sector-specific shocks.

Weighing on the outlook, the Dublin office market in particular has a significant supply pipeline and a high prevailing vacancy rate. While a strong pipeline of office space could potentially come on-stream in Dublin in the coming years, data from end-2023 indicate that delivery is being pushed out further into the future. In early 2023 for instance, an additional 530K sqm. was projected to come on stream in 2024 and 2025. By the end of 2023, that figure had dropped to 240K sqm. Similarly, projections for the space to be completed and brought to market beyond 2025 more than doubled from 330K sqm in early 2023, to 760K sqm by the year's end (Chart 11).

The office vacancy rate remains sensitive to the path for supply, remote working, and repurposing. Central Bank staff have updated a previously published scenario analysis which examined the potential impact of on-going structural change in the Dublin office market on its vacancy rate.[15] Based on a range of assumptions around (i) the office construction pipeline and take-up of space, (ii) the estimated level of lease expiration during the period, (iii) intentions to engage in remote working, and (iv) the degree to which existing office space may be repurposed in light of the practicalities/realities associated with these new ways of working, three scenarios are put forward. Under a central scenario, the vacancy rate is projected to move from a level of around 17 per cent at the end of 2023, to 18.5 per cent by the end of 2026. A more benign and more severe set of circumstances could see the vacancy rate move to around 15 or 26 per cent, respectively. The scenarios highlight the prevailing uncertainty in the market. Certain secondary, non-prime markets are likely to be particularly vulnerable to considerations around energy efficiency.

The market entered this shock with little evidence of significant overvaluation. Despite a global cyclical upswing in real estate markets in the years preceding and during the pandemic, the gap between CRE yields and the return on 10-year government bonds had been stable at around 5-6 per cent between 2015 and 2021 (Chart 12). This is consistent with valuation models that do not suggest Irish CRE prices moved out of line with fundamentals in the run-up to this shock. This suggests that significant overvaluation, which often leads to disorderly corrections, was not a feature of the pre-pandemic Irish CRE market. Rather, the adjustment in valuations is driven by fundamental shifts in underlying demand for space as well as the rapid increase in risk-free rates.

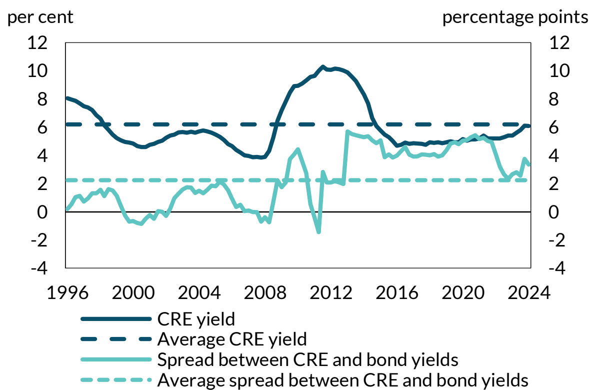
Following the rapid rise in interest rates since 2022, financial conditions have turned somewhat more accommodative recently. CRE is a globalised financial asset, meaning the trajectory for Fed and ECB rates is particularly important for investment and price expectations. Markets have been pricing in interest rate cuts by global monetary authorities in recent months. Expectations of easing of monetary policy, together with rising CRE yields, have led to a rise in the CRE risk

[15] See "COVID 19 and the commercial real estate market in Ireland", for more details on the original scenario analysis.

premium, which has moved above its long-run average. Continued falls in capital values would increase yields further, while falls in interest rates would further increase the risk premium, which would act as an additional support to investment demand. Looking at yields relative to a proxy for funding costs (5-year swaps), suggests that the compensation that investors receive for investing Irish CRE, over expected risk-free rates, remains above cross-country peers (Chart 13).

Chart 12: Relative returns on Irish CRE fell sharply under higher interest rates, but are now improving

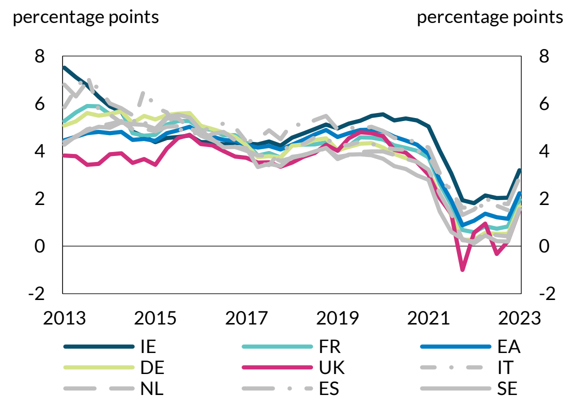
Irish CRE yield and risk premia



Source: MSCI, Bloomberg and Central Bank calculations.
Notes: Last observation 2024Q1.

Chart 13: Recent improvements in funding costs are combining with higher yields

Spread between CRE yields and 5 year swap rates



Source: MSCI and Bloomberg.
Notes: Swaps are 5-year Euribor for EA, UK and SE swaps, respectively. Latest observation 2023Q4.

A longer period of higher interest rates could pose significant risks to CRE globally. Difficulties stemming from "the last mile" of returning inflation rates to their target rate could mean that interest rates may remain higher for longer than currently expected, a risk that has been particularly evident in recent market pricing in the US (see *Global Risk Assessment* in accompanying *Financial Stability Review 2024:I*). Given the key role played by US investors in the global CRE market, this may somewhat delay the expected increases in CRE relative rates of return, posing downside risks to valuations. Outside of new investment appetite, a period of higher interest rates would mean borrowing costs remaining higher than expected, impacting CRE investors relying on debt funding and increasing risks for large pools of re-financing falling due in the coming years. The outlook for equity and fixed income markets will also remain relevant for those seeking market financing and in driving the relative rate of return for investment portfolios. Recent indications of markets "pricing for perfection", including compressed credit risk premia, leave open the risk that unpriced credit risk events in global CRE markets could lead to financial shocks.

Globally, the risk of financial distress emerging and propagating remains high, with the Irish CRE outlook exposed to a deterioration in investor appetite globally. The global CRE market shock has already created a number of high-profile incidents, including the collapse of Signa Holdings in Austria, as well as the difficulties faced by a number of US regional and smaller banks. Given the globally interconnected nature of the CRE market, and the ongoing adjustment of the global financial system to higher interest rates, elevated risks of further market surprises remain. In May 2024, property funds in the US, most notably Starwood's Sreit, experienced a continuation of outflows that has forced certain funds to draw heavily on available credit lines and opens up the possibility of forced property sales to meet withdrawals. While isolated to particular funds at the time of writing, such incidents pose the risk of broad propagation through the CRE market.

Resilience of the domestic financial system

While CRE investment and financing have become more diversified and globalised, domestic financial stability considerations still centre on the resilience of domestic banks and their borrowers. Domestic banks offer a full suite of financial services and lending across the Irish economy. For this reason, the resilience of their CRE borrowers, and the capacity of banks' balance sheets to absorb losses from CRE loans, remains central to domestic financial stability, despite the emergence of a wide variety of global sources of investment and financing. Borrowers from domestic banks include private investors and developers, real estate companies, as well as a cohort of Irish property funds.

Irish property funds are now a particularly important source of CRE investment, and are themselves borrowers of domestic banks in some cases. Irish property funds are Irish authorised investment funds that invest more than 50 per cent of their assets in Irish property assets. This source of CRE investment has grown rapidly over the past decade. The financial stability implications of the sector's activity differs from banks. Irish property funds are investment vehicles, raising finance through a mix of investor equity and loans. They use these funds to invest directly in Irish property assets. Irish property funds with high leverage or significant liquidity mismatch can amplify market stress or shocks by being forced to sell assets during a downturn. This *forced selling* can amplify the impact of the shock and potentially impairing the balance sheets of other property and real estate businesses across the CRE sector. In some cases, Irish property funds borrow from domestic banks, creating an interconnection between segments of the domestic financial system. In November 2022, the Central Bank announced policy measures to safeguard the resilience of Irish property funds.[16]

Non-bank lenders have become an important source of loan financing for domestic CRE investors and have a different funding model to banks. NBLs in Ireland are not subject to prudential regulation but issue loans to a similar – if riskier – profile of borrowers than domestic banks (Gaffney and McGeever, 2022). Differently from banks, NBLs do not fund these loans with customer deposits. For example, the liabilities of *Specialist Property Lenders* are typically a mix of group/parent funding and/or third party borrowing (Moloney et al., 2024). NBLs have grown in importance since the GFC, and account for an estimated 35 per cent of the domestic borrowing of Irish real estate businesses (Lambert, Mahony, McGeever, 2024), this rises to 50 per cent of new lending for real estate SMEs (see FSR 2024:I). As many NBLs lending to real estate businesses and investors are specialists, they are subject to concentration risk (Moloney et al., 2024).

There is uncertainty over the resilience of NBLs' balance sheets, but the wider domestic financial stability implications of losses in this sector are smaller when compared to banks. The resilience of this source of finance is a key source of uncertainty globally, given its relatively recent emergence, difficulties in assessing the true scale of leverage, funding structures and ultimate related counterparties, and lack of experience through a full financial cycle. The specialist nature of many property-lending NBLs and the sensitivity of their funding sources make them a potential source of amplification *within* the domestic CRE market. However, losses experienced by the *specialist*

[16] See the Central Bank's Macroprudential Measures for Property Funds.

lenders are less likely to cause wider shocks to credit supply across the economy, given that the majority do not provide financing to broader parts of the economy.

Credit risks for CRE loans relate both to recurring debt service ability, as well as to property valuations and LTVs. CRE loans are shorter in duration relative to mortgages and often require rollover or refinancing. Credit risk typically involves elements of both recurring repayment risks and refinancing risks at maturity. Recurrent repayment risks, captured in metrics like the Interest Coverage Ratio, derive from changes in interest rates, or reductions in borrowers' net operating income (rent minus expenses). Due to the nature of the repayment structure, balloon payments are often due at the maturity of CRE loans, meaning that borrowers must refinance either with their bank or with an outside lender. The LTV profile is the key risk driver in this regard, and creates a direct link to the broader external risk environment in which global shocks can lead to downturns in the valuation of CRE properties in Ireland. Where valuations do fall significantly before the refinancing stage, an increase in LTVs can lead to difficulties, with re-appraised LTV levels potentially falling outside lenders' appetite. This can leave borrowers at risk of needing alternative sources of refinancing, or requiring equity injections to avoid entering default.

Falls in commercial property values can have implications for domestic borrowing and investment through weaker corporate balance sheets. Beyond the direct financial implications for lenders and borrowers, shocks to real estate values can have broader implications across the economy in cases where non-real-estate businesses use their properties as collateral for borrowing or where falls in real estate prices reduces the net worth of businesses. International research provides clear evidence on the importance of real estate valuations for businesses' net worth, and the knock-on implications of falls in their collateral values on their ability to borrow and invest.[17] This is a particularly important channel for the owner-occupied segment of the commercial real estate market, which – in itself – is affected by dynamics in the broader market.

Since the financial crisis, deleveraging and weak credit demand mean the real economy has become less exposed to fluctuations in real estate prices through the collateral channel. Irish businesses, and the Irish economy more broadly, are less credit-intensive, and less reliant on real estate, than was the case in the past. Between 2012 and 2015, the share of Irish SMEs applying for loans was consistently between 30 and 40 per cent, but has stood at 17 to 20 per cent since 2020, according to Department of Finance *Credit Demand Survey* (CDS) data. SMEs not applying for credit typically indicate that they have sufficient internal funding to finance investment, and do not indicate in large numbers that access to financing is an impediment to their expansion. On a cross-country basis, SAFE data from the ECB indicate that the application rate for loan finance for Irish SMEs has been on average around 2/3 of the EU average level.

Even when Irish businesses do borrow, the usage of physical collateral is less common than in the past. Central Bank analysis of the CDS indicates that, even among the one-fifth of SMEs that

[17] Macroeconomic models have long identified that, through the pledging of physical collateral, businesses can increase their borrowing, and this can have implications for the amplification of business cycles through a collateral channel effect (Bernanke and Gertler (1987); Kiyotaki and Moore (1997)). Empirically, Chaney, Sraer and Thesmar (2012) show that, in the US, corporate investment responds causally to increases in the value of businesses' real estate holdings, and that this is driven by additional borrowing which is facilitated by the easing of credit constraints. Focussing on real estate values of business owners, Bahaj, Foulis and Pinter (2020) show that house prices have a similar causal effect on corporate investment through the relaxation of financial constraints.

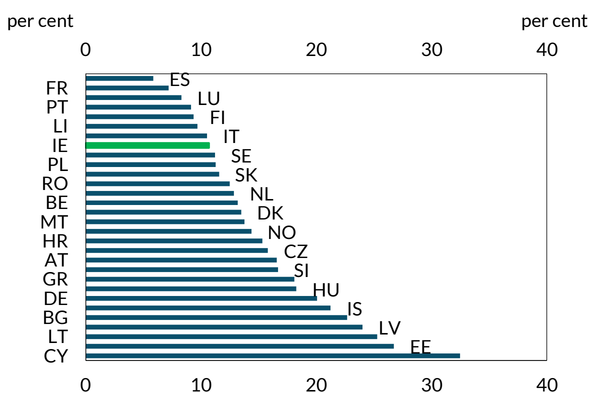
applied for credit in 2023, only one-third posted collateral (down from 44 per cent in 2017), and of those, just over a quarter were secured on land or buildings. The falling importance of real estate collateral means that transmission of the CRE price shock through company balance sheets in the real economy is less significant than would have been the case in the run-up to 2008, when greater proportions of Irish business borrowing and activity were tied up in real estate activity (McCann and McIndoe-Calder, 2015).

Domestic Banks

Irish domestic banks have a diversified CRE loan book that is now a much smaller share of their total balance sheet. The domestic banking sector has close to €12 billion of loan exposures to the Irish CRE market.[18] CRE lending in total represents 11 per cent of total domestic loans. By contrast, estimates of the size of real estate lending before 2008 suggest the equivalent balance sheet share was above 30 per cent (Lyons et al., 2019). The materiality of Irish banks' CRE loan exposures as a share of total household and NFC lending is around the European average (Chart 14). In terms of the composition of exposures, the office and residential segments are the two most important in banks' CRE portfolios. Relative to Irish property funds however, Irish banks are proportionately more exposed to residential, and less exposed to the higher-risk office market.

Chart 14: Irish exposure to CRE loans close to European average

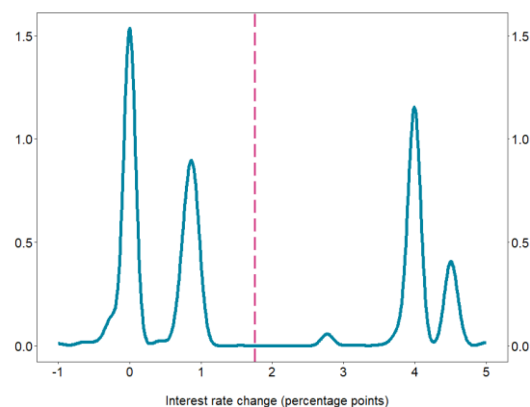
Share of CRE in total loans



Source: EBA Risk Dashboard (2023Q4).
Notes: CRE loans to total NFC and household loans. Data covers a sample of domestic and international banks resident in Ireland and is based on loans collateralised by commercial property to non-financial institutions.

Chart 15: Interest rate changes have varied across CRE borrowers, with many insulated by fixed rates

Interest rates on CRE loans, 2021-2023



Source: Central Bank of Ireland.
Notes: The distribution of interest rate changes between December 2021 and December 2023 on domestic bank loans owed by Irish CRE borrowers with a balance still outstanding in December 2023. The dashed line represents the balance-weighted average interest rate change. See Lambert, Mahony and McGeever (2024).

Underwriting standards for CRE lending have improved since the Global Financial Crisis. The vast majority of domestic banks' CRE loans are for investment (meaning the purchase of property already constructed and often involving a pre-existing rent roll) while close to one-tenth is estimated to be for development (an inherently higher-risk activity). This is in stark contrast to the

[18] Defined under the narrow definition of income-generating property, rather than the broader ESRB definition used in some other international reports. The Irish market makes up almost 70 per cent of domestic banks' CRE loan exposures. They also have exposures of around €4 billion in other jurisdictions, primarily the US and UK.

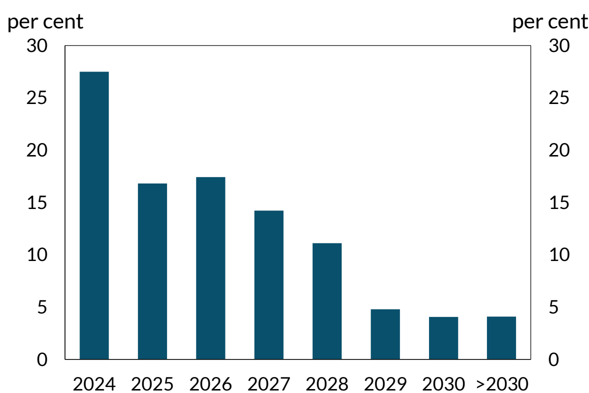
pre-2008 position, where development finance was more widespread, with credit conditions associated with development finance looser, and high-risk exposures more concentrated.

Increases in monetary policy interest rates since 2022 are not fully reflected in interest rates across the CRE loan book, due primarily to interest rate fixation. Over the two years to end-2023, the average CRE interest rate at domestic banks, when weighted by loan size, has increased by around half the size of the increase in the ECB policy rate over the same period. While banks do appear to be passing on increases in the cost of funds to many borrowers on variable rates, this partial overall pass-through of tighter monetary policy is explained by the substantial share of CRE borrowers on fixed-rate contracts, and somewhat incomplete pass-through on a portion of variable rate loans (Chart 15, see also Lambert, Mahony and McGeever (2024)). From a resilience perspective, similar to the mortgage market, this incomplete pass-through of the ECB's policy stance since 2022 has provided insulation to CRE borrowers who otherwise would have experienced much sharper increases in their debt service burdens.

Refinancing is a key source of risk, but risks are being contained by a gradual maturity profile. Given the sharp falls in some CRE valuations experienced in the past two years, loan refinancing in the current environment is particularly vulnerable to the impact of higher LTVs on banks' appetite and capacity to continue lending. From a bank and borrower resilience perspective, therefore, a gradual maturity profile over the years 2024-28 is supportive, with about a quarter of the CRE book falling due for refinancing this year and a consistent share of around 15 per cent in each year to 2028 (Chart 16). Longer times to maturity support resilience by avoiding the risks that could come with a large "refinancing cliff", enabling banks to manage these complex, bespoke cases in a more gradual manner.

Chart 16: A quarter of banks' CRE loans mature this year, with a gradual refinancing profile out to 2028

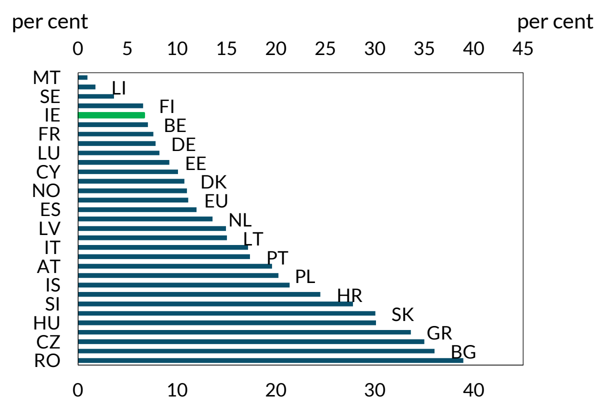
Domestic bank CRE loans by year of maturity



Source: Central Bank of Ireland.
Notes: The share of performing domestic bank Irish CRE outstanding balances by loan maturity year. See Lambert, Mahony and McGeever (2024).

Chart 17: Irish banks have a relatively favourable LTV profile, providing capacity to absorb the downturn

Percentage share of CRE loans with LTV >100 per cent



Source: EBA June 2023 data.
Notes: Data cover a sample of domestic and international credit institutions resident in Ireland and is based on loans collateralised by commercial property to non-financial institutions.

Irish banks' LTV profile is supporting borrowers during this shock, but risks and uncertainty remain. End-2023 data indicates that – even after the substantial declines in valuations – weighted average LTVs of domestic bank CRE loans were between 50 and 60 per cent (Lambert, Mahony, McGeever, 2024). EBA data confirm that, relative to European peers as at June 2023, Irish banks'

LTV profile was supportive, when looking at the tail of the distribution (Chart 17). While this implies an equity cushion is available to absorb price falls without borrowers entering negative equity, the ongoing downturn in office and retail, coupled with continued uncertainty around the market outlook, means that further increases in LTVs are possible, particularly in cases where collateral revaluations have been less frequent.

CRE loan books are concentrated, with the largest borrowers having relatively large exposures. The granularity of CRE portfolios is an important risk consideration. In concentrated portfolios, even when broader market fundamentals are sound, idiosyncratic difficulties at a small number of very large borrowers can have meaningful portfolio-wide consequences. The Irish domestic bank CRE portfolio has a degree of concentration, with more than half of CRE debt accounted for by the largest few hundred borrowing firms, meaning that active management of these large exposures is particularly important in this portfolio.

Headline bank risk metrics are not yet pointing to a large increase in borrower distress. A key metric of loan distress, the IFRS9 Stage 3 ratio, has increased moderately from 4.8 to 6.4 per cent from 2022 to 2023. The relatively contained increase suggests that the full magnitude of the CRE market shock is not yet being felt on borrower and bank balance sheets. Similarly, at a market-wide level, real estate company receiverships have not yet increased significantly (Chart 18). Loans falling due for refinancing in 2023 were successfully refinanced in the majority of cases, with a moderate number of cases migrating to non-performing exposures. Where equity injections were required to bring LTV levels into line with targeted levels, borrowers were generally willing to commit additional equity.

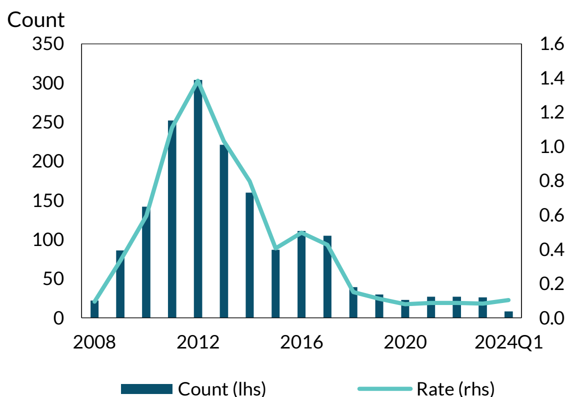
However, these headline numbers mask a number of emerging trends that the Central Bank will continue to monitor closely and lenders need to manage actively. Flows into loan default have indeed risen across the CRE book, as would be expected given the size of the increase in interest rates and falls in CRE prices. These have not translated into a significance increase in the stock of NPL or Stage 3 loans, because a proportion of these NPLs have been removed from bank balance sheets via loan sales, property collateral realisation and to a lesser extent NPL portfolio sales. Forbearance has also been used by the banks to manage borrower distress, and has in some cases slowed the pass-through from borrower distress to headline indicators on bank balance sheets.

Global CRE market and capital market dynamics will have direct implications for the ability of Irish banks to manage distressed loans. The availability of loan sales as a distress management tool provides an alternative to seeking a sale of the underlying property, third party refinance or a workout of a loan exposure. However, further shocks to investment appetite in the global CRE sector, or broader adverse shocks to financial conditions, could impair banks' ability to manage their distressed portfolios through such sales. The absence of a sales option for distressed assets, driven by exogenous factors outside their control, would increase the risks to banks' balance sheets from CRE borrower distress.

Provision coverage has risen in recent years, in line with European developments and acknowledging the building risks in the CRE market. Bank provisions cover expected losses, and have almost doubled on CRE loans in the past year, in line with the increased risk profile in a setting of higher borrowing costs and falling property values. Relative to European banks,

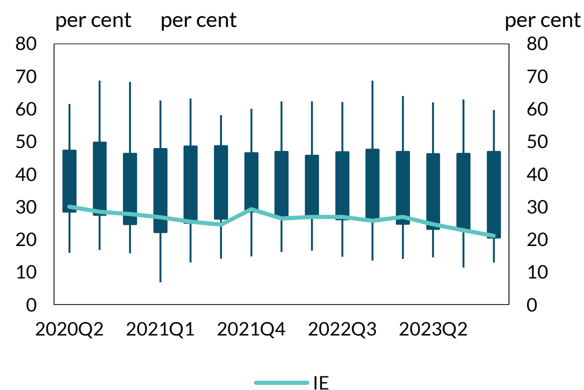
provisions for Irish banks are slightly above the European average for performing loans, but are significantly lower than average for NPLs (Chart 19).[19] These differences may in part be driven by a range of compositional factors, such as the LTV profile of CRE lending, and the impact of regulatory calendar provisioning, where banks can recognise losses through capital deductions rather than through provisioning. As provisions are based on a point in time assessment of expected losses, they will change with the financial cycle and remain vulnerable to sharp changes that could emerge with changes in key underlying risk factors.

Chart 18: Despite market distress, the number of real estate company receiverships remains low
Commercial real estate company receiverships in Ireland



Source: Companies Registration Office and CSO.
Notes: The number and share of CRE firms entering receivership. See Lambert, Mahony and McGeever (2024).

Chart 19: Irish banks' provision on CRE NPLs is at the low end of the European distribution
Provision coverage ratio on NPLs in EU



Source: EBA Risk Dashboard (2023Q4).
Notes: data covers a sample of domestic and international banks resident in Ireland and is based on loans collateralised by commercial property to non-financial institutions. Teal line denotes Irish banks.

At present, banks' balance sheets remain resilient to the CRE shock, owing to the smaller size of CRE exposures and the current level of capital headroom over regulatory requirements. The Central Bank's assessment is that, particularly given the smaller share of CRE in total loans, banks' capital headroom currently provides sufficient capacity to absorb adverse shocks to the CRE portfolio. To gauge banks' resilience to the shock, the Central Bank has conducted a reverse stress test, considering how material the losses on Irish banks' CRE exposures would need to be under different scenarios to erode key metrics of resilience. In a baseline scenario, where the rest of the economy continued to evolve in line with baseline projections from the European Banking Authority (EBA) 2023 stress test, a cumulative three-year loss rate of around 40 per cent on CRE exposures would be required to erode all pre-distribution profits out to 2026 (equivalent to a cumulative default rate of 80 per cent at a loss given default or LGD of 50 per cent).[20]

Even under an adverse scenario for non-CRE loans, existing bank capital buffers could absorb substantial losses. If the rest of the economy suffered a widespread adverse shock at the same time as a CRE downturn, the banking system would also incur losses on non-CRE exposures, limiting its capacity to absorb CRE-related shocks. Even in this eventuality, material loss-absorbing

[19] See EBA Risk Dashboard 2023Q4.
[20] The loss rate of 40 per cent from this exercise erodes all profits *before* dividend distributions are taken into account. If banks were to distribute a portion of their profits through dividend payments over the scenario horizon, a smaller CRE loss rate would be required to erode remaining projected profits.

capacity exists in the domestic banking system. If domestic banks experienced capital depletion levels at the most severe of previous EBA stress test adverse scenario outcomes (around 7pp of CET1 depletion), they would remain above minimum regulatory requirements. The cumulative three-year loss rate on CRE exposures would need to reach around 25 per cent to erode capital levels down to minimum regulatory requirements.[21] This would be equivalent to the loss rates experienced on CRE during the GFC (during which CRE debt outstanding was much larger than today and CRE price falls far exceeded those currently being experienced).[22]

Irish Property Funds

Irish property funds are a key participant in the Irish CRE market. The funds have approximately €29 billion in Irish property holdings, including €6.5 billion in indirect property investments. The funds are invested in the main subsectors within the CRE market, including industrial and retail, with the office and the residential sectors being the largest in terms of asset exposure. The importance of the sector within the CRE market means that the Irish property funds' resilience can have implications for the broader functioning of the CRE market.

Leverage in the sector remains a key focus, particularly due to the ongoing downturn in the CRE market. Funds with high leverage (exceeding 60 per cent) accounted for approximately 42 per cent of the sector's total assets at end-2022. Highly leveraged funds are more vulnerable to shocks to the CRE sector and more likely to amplify rather than absorb those shocks. As CRE prices have been falling in 2023, this is likely to have had an impact on valuations and, potentially on current levels of leverage. The latest valuation figures reported to the Central Bank are for end-2022. To estimate 2023 valuations and leverage levels, valuations for cohorts of funds within the sector are projected forward using CRE indices values for 2023. This projection suggests that – assuming no pro-active actions to manage leverage have been taken (e.g. additional equity injections) – weighted average leverage increases in the sector from 53 per cent to an estimated 59 per cent, with the projected increase in leverage particularly significant for those funds invested mainly in the retail and office sub-sectors.[23] This underpins the importance that funds manage leverage-related risks carefully, including through additional equity injections from investors, where relevant.

Irish property funds' leverage is largely sourced via bank and non-bank debt, and shareholder loans. Interconnectedness between Irish property funds and banks is a key channel through which these funds can impact credit supply and the real economy. As of end-2022, Irish property funds had around €6.5 billion outstanding in bank debt, accounting for 36 per cent of their total leverage. Outstanding shareholder loans accounted for nearly €2 billion in debt, with most of this issued between 2016 and 2019. Approximately €1.1 billion or 86 per cent of the shareholder loans outstanding as of end-2022 will either mature or be converted to equity by end 2027. Industry

[21] This would be equivalent to a cumulative default rate of around 50 per cent combined with an LGD of 50 per cent.
[22] Comparisons of loss rates in the current scenario versus the GFC are conducted after adjusting for the changed composition and varying loss rates on banks' CRE portfolios between investment and riskier development activity.
[23] The projection of leverage is computed by applying the percentage change in market valuations in 2023 to 2022 funds' holdings data. Debt is assumed to remain constant at 2022 levels. Office and retail make up over half of Irish property fund portfolios. Funds are categorised in office, retail, industrial, residential and other based on the category in which they have more than 50 per cent of exposures. Other includes funds that have more than 50 per cent of exposures in other assets and funds which don't have more than 50 per cent of exposures concentrated in a single category.

engagement suggests that the majority of the maturing shareholder loans are expected to be converted to equity, which – everything else equal – will lead to a reduction of measured leverage.

The Central Bank introduced macroprudential measures in November 2022 for Irish property funds and continues to monitor the sector closely, particularly in relation to leverage-related vulnerabilities. On 24 November 2022, the Central Bank announced new macroprudential measures for Irish property funds to safeguard Irish financial stability. The macroprudential measures ('the measures') consist of a 60 per cent leverage limit and new Central Bank Guidance to mitigate liquidity mismatch in Irish property funds. The Central Bank is currently focused on ensuring appropriate progress is being made throughout the five-year implementation period for the leverage limit and that fund managers are managing leverage-related vulnerabilities actively.

Non-Bank Lenders

NBLs provide diversification of financing for domestic borrowers and while predominantly unregulated, domestic NBL lending is visible to the Central Bank within the CCR. NBLs provide an alternative source of financing for domestic borrowers, increasing access to finance and competition in the sector. NBLs are not subject to prudential regulation. However, the activity of an individual NBL can be affected by certain regulations based on specific activities that they carry out. The Central Bank collection of activity-based lending data in the CCR facilitates monitoring of the sector, although a certain level of opaqueness remains.

Domestic NBL real estate lending is becoming a substantial share of total real estate lending. Central Bank research estimates that the NBL share in domestic SME new lending is around 30 per cent, and closer to 50 per cent for new lending for real estate SMEs (see FSR 2024:I). Estimating the NBL share in lending to all real estate business is more challenging, with larger non-SME real estate borrowers often the most opaque. Using the CCR data, recent analysis by the Central Bank estimates the NBL share in reported borrowing by domestic real estate businesses may be around 35 per cent (Lambert, Mahony, McGeever, 2024). Relative to a domestic bank CRE loan book of around €12 billion, this experimental estimate suggests domestic NBLs' CRE lending would be approximately €6.5 billion.

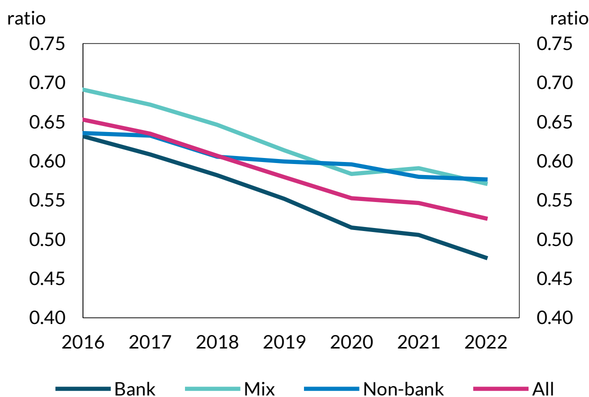
The total size of non-bank loan financing of Irish CRE is likely to be higher than the amounts observed in the CCR. Non-bank entities outside Ireland, such as private credit funds for example, can lend directly to Irish companies for the purpose of purchasing Irish investment property. Similarly, non-bank entities outside Ireland can lend directly to foreign funds or investors that can directly purchase Irish property from overseas. In these cases, financial exposures may not be captured in granular data available to the Central Bank. Given the nature of this financing, the financial implications of loan defaults or falls in asset values would not have the same direct implications for core Irish financial system balance sheets. It is likely, based on the globalised nature of real estate financing, that there is cross-border financing of CRE investment in Ireland that is not captured through data available to the Central Bank.

CRE borrowers at NBLs are typically more leveraged than borrowers at banks, and pay higher interest rates than banks' CRE borrowers. International research typically shows that borrowers with a higher risk profile are more likely to source financing from NBLs, as opposed to banks. In

Ireland, Gaffney and McGeever (2022) confirm, using CCR data, that Irish businesses that borrow from NBLs have higher leverage, weaker liquidity, and are younger than banks' customers. For real estate borrowers, this pattern of higher leverage among NBL customers is confirmed in the years leading up to the onset of the COVID-19 pandemic, 2016 to 2022 (Chart 20). This indicates that, all else equal, NBL borrowers entered this downturn with less capacity to absorb shocks to market valuations on their balance sheets than borrowers of banks.

Chart 20: NBLs' real estate borrowers had higher levels of book leverage than bank borrowers in the run-up to this shock

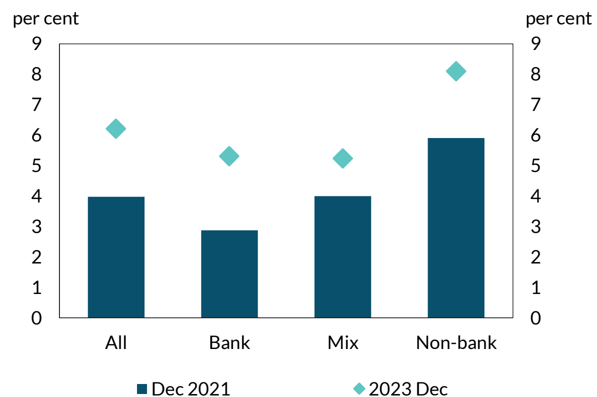
Book leverage of real estate borrowers



Source: Central Credit Register, Companies Registration Office and Dun & Bradstreet.
Notes: The median ratio of total liabilities to total assets of Irish CRE companies with outstanding borrowings in December 2023 by lender type. 'Bank' refers to borrowers with loans owed solely to banks, 'Mix' to borrowers with bank and non-bank loans, and 'Non-bank' to borrowers with only non-bank loans. See Lambert, Mahony and McGeever (2024).

Chart 21: NBL's real estate borrowers pay higher interest rates, but pass-through since 2022 has been similar

Interest rates on real estate lending



Source: Central Credit Register.
Notes: The balance-weighted average interest rate paid by Irish CRE borrowers in December 2021 and December 2023 by lender group. 'Bank' refers to borrowers that exclusively borrow from banks, 'Mix' to those that borrow from banks and non-banks, and 'Non-bank' to those that borrow exclusively from non-banks. See Lambert, Mahony and McGeever (2024).

Broader credit risk developments during this CRE downturn appear similar at NBLs to those at banks, with little evidence of widespread loan distress emerging so far. CCR data suggests that while interest rates for NBL CRE borrowers are higher than at banks, monetary policy pass-through for outstanding loans has been similar to CRE loans for bank borrowers (Chart 21). The balance-weighted average interest rate on NBL loans increased by approximately 225bps since the beginning of the ECB's monetary tightening in mid-2022 (Lambert, Mahony, McGeever, 2024). Market intelligence and information available in the CCR suggests a similar picture to banks, with some pockets of difficulty emerging and a broadly contained increase in arrears so far, but refinancing issues being actively managed and typically resolvable without recourse to collateral.

While the reduction in new lending by NBLs in 2022 has recovered in 2023, the underlying resilience of NBL balance sheets remains a source of uncertainty. Given their limited regulatory footprint, and challenges in gathering data on ultimate underlying ownership, funding sources and related counterparties, the NBL sector remains a source of uncertainty for the domestic CRE outlook. The risk of further financial distress in the global CRE sector, particularly in the context of *higher-for-longer* interest rates, means that a retrenchment in investor appetite remains a key risk. NBLs, through their interconnections to global financial entities, could become a source of transmission for these broader global shocks, leading to a retrenchment in credit supply in the domestic market and potentially contributing to ongoing weakness in the CRE outlook. Evidence

of a reduction in new lending was demonstrated in 2022 but has recovered in 2023 (see FSR 2024:I). The recovery of non-bank lending in 2023 suggests that financial institutions funding non-bank lenders still have appetite for exposure to non-bank lending, despite the higher interest rate environment increasing the risk of default and the cost of finance. In this context, a continued focus on this sector, its lending appetite, and the underlying financial structures (in the spirit of Moloney et al., 2023) behind this growing source of domestic CRE financing, will remain an important area for monitoring and assessment.

Conclusions of the assessment

The global and Irish CRE markets have been undergoing a series of fundamental adverse shocks. Changes in the use of office space and increases in e-commerce since the pandemic have fundamentally altered the demand profile of the office and retail markets. At the same time, since 2022, the sharp rise in global interest rates necessary to fight inflation has sharply altered the financial position of many CRE borrowers and investors. Against this backdrop, the Irish CRE market has experienced a 27 per cent fall in valuations, with the possibility that further falls may lie ahead. Risks appear particularly acute in the office market where rents may not yet have fully adjusted to post-pandemic working practices, and the vacancy rate continues to rise.

The Central Bank judges that the domestic banking system continues to have capacity to absorb, rather than amplify, the CRE shock. CRE lending has fallen dramatically in importance over a fifteen-year horizon, from over one-third of Irish bank loans to around one-tenth. At the same time, Irish banks' underwriting criteria have been more prudent, and the LTV profile has provided a substantial cushion to absorb recent declines in CRE valuations. Uncertainty remains around the ultimate impact of the market decline on CRE borrowers, and the Central Bank's supervisory focus remains on banks' risk management practices, including the management of the pipeline of loans approaching refinancing or at risk of entering financial distress. Overall, the size of banks' current capital buffers and headroom, combined with the smaller size of the CRE book, provides sufficient capacity to absorb losses on CRE loans without compromising their capital resilience.

The Central Bank does not see the shock to the CRE market as warranting a change in the CCyB rate on Irish exposures under current conditions. The CCyB rate on Irish exposures is currently set at 1.5 per cent. This stance was confirmed, following the Central Bank's latest quarterly review, in *Financial Stability Review 2024:I* published alongside this *Special Feature*. The 1.5 per cent rate supports the resilience of the banking sector – proportionate to the risk environment – with a view to facilitating a sustainable flow of credit to the economy through the macro-financial cycle. The CCyB can be released where a materialisation of cyclical systemic risk or a downturn is identified, to facilitate the banking system to absorb losses and maintain the supply of lending to the economy. As discussed above, to date the banking system has absorbed the CRE shock in an orderly manner, with key bank risk metrics not yet pointing to a meaningful increase in borrower distress. The banking system overall is expected to continue to remain profitable, which means that – in the central case – capital buffers will not need to be used to absorb losses.

There are vulnerabilities within the non-bank sector that will remain a key focus for the Central Bank. In the non-bank sector, there is a cohort of Irish property funds that may be more vulnerable

to shocks. In November 2022 the Central Bank announced policy measures to safeguard the resilience of the sector so that it is more likely to absorb rather than amplify shocks. The Central Bank continues to monitor the sector during the implementation period of these measures for Irish property funds. Another area of focus for the Central Bank is the activity and resilience of non-bank lenders. Given that many NBLs with CRE exposures are specialists, focused almost exclusively on real estate lending, they are less likely to be a source of amplification to other domestic financial institutions or households. However, they are subject to concentration risk and may have more sensitive sources of financing than banks. Within the CRE market, these NBLs have grown in importance to the point where their balance sheet resilience can have meaningful impacts on the availability of credit and the Irish CRE outlook.

A more diverse CRE financing landscape is supporting domestic financial stability. Overall, the more diversified sources of financing and the resilience of the core banking system means that some of the most acute risks to domestic financial stability are broadly contained. However, the risk landscape continues to evolve, with uncertainties around certain key market participants, especially certain NBLs and cross-border activity. The Central Bank will continue to assess the financial stability implications of the ongoing CRE market adjustment. More broadly, the changing nature of financing means that there are important data gaps in this area, which complicate assessment of financial stability vulnerabilities. The Central Bank will continue to explore options for addressing these.

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