

INITIATIVES TO STRENGTHEN RISK MONITORING IN THE COMMERCIAL REAL ESTATE SECTOR

The commercial real estate sector deals with the acquisition, financing, construction, development and management of properties in which economic activities are carried out. This type of property includes, among other categories, commercial premises, such as shops and hotels, offices and industrial buildings.¹ Supervisory authorities, at both the European and Spanish level, have followed this type of activity closely. Its importance derives mainly from the fact that these properties are a necessary production factor for companies in other sectors to carry out their activities. Also, by its very nature, the commercial real estate sector follows similar dynamics to the residential real estate sector. These properties, as in the case of housing, are potentially illiquid assets and can undergo processes of overvaluation and undervaluation that intensify both the financial upturns and the downturns in which systemic crises occur.

Given the importance of the commercial real estate sector, the ECB and the Single Supervisory Mechanism (SSM) commenced work in 2021 to strengthen its supervision.² On the macroprudential side, following careful analysis of this type of activity, at the end of 2022 the European Systemic Risk Board (ESRB) adopted [Recommendation ESRB/2022/9 on vulnerabilities of the commercial real estate sector](#). This recommendation aims to improve the oversight of risks in this sector, to ensure that financial institutions adequately address these risks and to ensure that all supervisory authorities (banking and non-banking), have the necessary prudential tools at their disposal and apply them appropriately.

The recommendation is divided into four sub-recommendations.³ This box focuses exclusively on sub-recommendation A, as the Banco de España is its main target in Spain, and the deadline for its compliance is the nearest.⁴ This sub-recommendation calls for the authorities to closely monitor current and emerging vulnerabilities related to commercial real estate, by assessing the cyclical

stage of the commercial real estate market and monitoring developments in commercial property prices, the income flows generated by commercial real estate and the financing conditions and sources in this sector, as well as the interconnectedness with other economic and financial sectors.

The Banco de España has adopted this recommendation and has launched a series of tasks to reinforce its monitoring of this sector. Firstly, a project has commenced in order to assess the level of imbalances in commercial real estate prices at different points in time. Secondly, work has intensified on the analysis of the various data sources available to the Banco de España that are relevant to the analysis of the commercial real estate market, which will allow close monitoring of the evolution of transactions and prices in this sector and of the financing of the companies that carry out this type of activity, together with information on their balance sheets and their interconnections with the rest of the economy and interlinkages between countries.⁵

As regards the bank financing of this sector, the weight of commercial real estate lending by Spanish institutions was close to 4% of total lending at the end of 2023.⁶ This proportion is lower than in Spain's main neighbouring countries. For example, for the European Union as a whole, banks' exposures accounted for just over 6% of total lending at the end of last year. If banks' exposure to this sector is taken on an individual basis, in the case of Spanish institutions, this lending accounted for 6.3% of GDP at 2023 year-end.

The work that has already been carried out includes most notably the development of a hedonic price index for commercial real estate. The hedonic nature of the indicator guarantees the possibility of monitoring the price evolution of properties with homogeneous characteristics.⁷ Chart 1 shows the evolution of this index for the commercial real

1 Residential buildings for rent can also be considered as commercial activities.

2 See "Commercial real estate: connecting the dots", article published in the ECB's *Supervision Newsletter* on 17 August 2022.

3 Sub-recommendation A, addressed to financial stability authorities; sub-recommendation B, addressed to supervisory authorities; sub-recommendation C, addressed to competent authorities; and sub-recommendation D, addressed to the European Commission.

4 In particular, the Banco de España must report on compliance by 31 March 2024 at the latest. A new assessment of this sub-recommendation will be carried out on 31 March 2026.

5 These sources would be the Banco de España's Central Credit Register, the Association of Registrars (with information on real estate transactions) and the Central Balance Sheet Data Office (with information on companies' balance sheets). Information on securitisations of commercial real estate backed loans granted is also available via the *European DataWarehouse*.

6 Based on consolidated information from the EBA's risk monitoring framework.

7 This is achieved through regressions that take into account categorical variables relating to the location of the property or other characteristics. For more details, see M. Lamas and S. Romaniega. (2022). "Designing a price index for the Spanish commercial real estate market". Occasional Papers, 2203, Banco de España.

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In year-on-year terms, commercial property prices fell moderately until September 2023 (although since March of this year there has been an increase), and there was a certain loss of momentum in the business indicators (sales and loans).

Chart 1
PRICE INDEX FOR COMMERCIAL REAL ESTATE SECTOR (a)

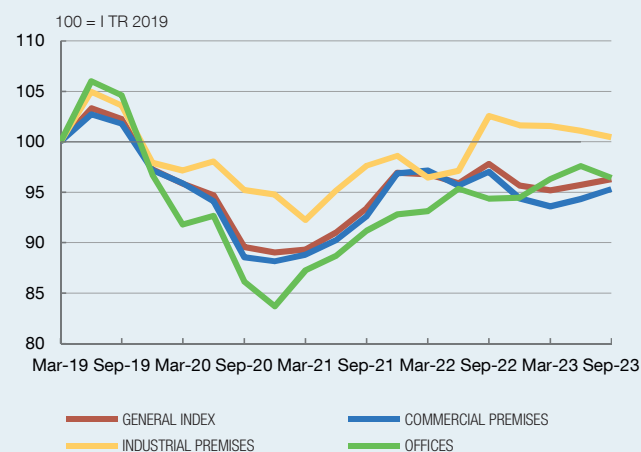
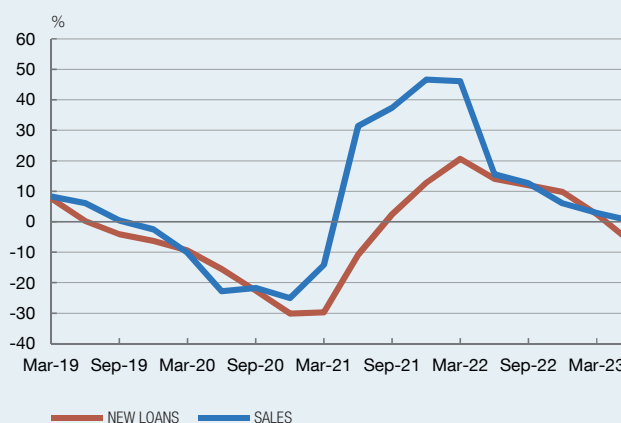


Chart 2
YEAR-ON-YEAR CHANGE OF COMMERCIAL REAL ESTATE SALES AND LOANS



SOURCES: Banco de España and Association of Registrars.

- a Based on estimates with a hedonic regression model in each stratum. The aggregate index is the average weighted by the relative weight of transactions carried out in each segment (4% offices, 78% commercial premises and 18% industrial premises).
- b Sales of commercial premises, offices and industrial premises. The new mortgages considered are secured by these properties. The information on sales and mortgages for 2023 Q3 is still partial and not depicted in the chart. Moreover, the annual changes shown are the average year-on-year rates for the last four quarters.

estate sector as a whole and for some of the most representative types of establishments. As can be seen in the chart, commercial real estate prices suffered during the pandemic, although in 2021 they recovered to their pre-pandemic level. In 2023, however, there was a moderate price contraction (with the information available in Q3 2023, the year-on-year change in the price index was -1.6%).

The price behaviour of this type of establishment contrasts with the sector's activity indicators (Chart 2). According to information from the Association of Property Registrars (*Colegio de Registradores de la Propiedad*), and with data

up to Q2 2023, in the last year there was a year-on-year fall of 2.8% in the number of new sales of these properties. At the same time, this period saw a year-on-year decrease of 24.8% in new loans secured by this type of property. If this decline in activity was to consolidate persistently, it could have wider implications for commercial real estate prices and for economic activity and financial stability.⁸ In addition, it should be noted that the balance of commercial real estate loans on the balance sheet of Spanish banks is relatively small compared to the balance of residential loans: it accounted for 8% of banks' total private sector loan balance at the end of 2023, as compared to 44% for residential real estate loans.⁹

⁸ In the event of falling real estate prices, the value of real estate collateral declines, which affects agents' lending capacity or, in the case of defaults, loan recovery rates. Moreover, a less dynamic commercial real estate sector, which encompasses the activity of developers and builders, could have some impact on employment and reduce household incomes, implying a risk to financial stability.

⁹ Based on supervisory information from the Banco de España (individual data, businesses in Spain).