

Box A: International Commercial Property Developments

Over recent years, commercial property prices have risen strongly in many countries. Where increases have been large they have typically been broadly based: across offices, retail and industrial properties, and evident both in direct property indices and listed property trusts (Table A1 and Graph A1). As in residential property markets, price growth has generally been strongest in English-speaking countries.

Table A1: Commercial Property Prices

Year-ended percentage change in capital values

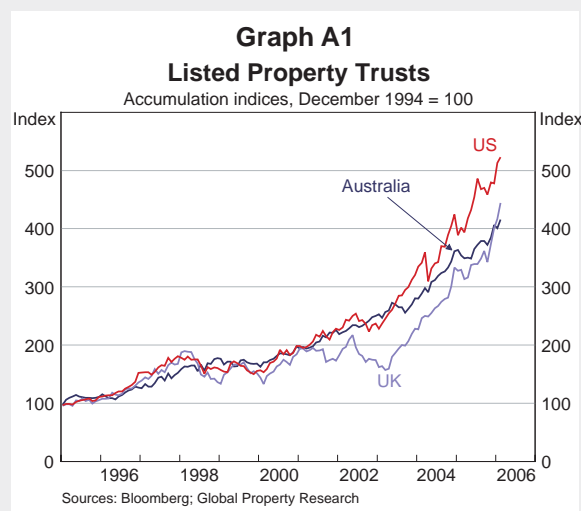
	All commercial property		Office property	
	Year to Dec 2005	Three years to Dec 2004 ^(a)	Year to Dec 2005	Three years to Dec 2004 ^(a)
Australia	–	–	11.7	1.9
Canada	10.1	1.4	9.3	-0.9
Ireland	18.1	3.0	16.7	-2.0
New Zealand	8.8	2.3	8.2	1.4
United Kingdom	12.8	5.8	13.4	-0.2
United States	11.3	5.7	11.8	3.6
Germany ^(b)	–	-2.1	0.0	-15.3
Japan ^(c)	–	–	-7.0	-9.9
Singapore	–	–	4.5	-9.6

(a) Average annual percentage change.

(b) Office data relate to Frankfurt only.

(c) Data relate to year(s) to September. Office data include retail property.

Sources: Investment Property Databank; Japan Real Estate Institute; Jones Lang LaSalle; Property Council of New Zealand; Singapore Urban Redevelopment Authority; US Federal Reserve



The upward pressure on prices partly reflects strong fundamentals, with economic growth contributing to an increase in rents and declining vacancy rates in many countries. But developments also appear to reflect strong investor demand, particularly from pension funds seeking assets offering long-term income streams at high yields.

As in other asset markets, the rise in prices has been associated with an increase in borrowing. In many countries, banks have increased lending to the commercial property

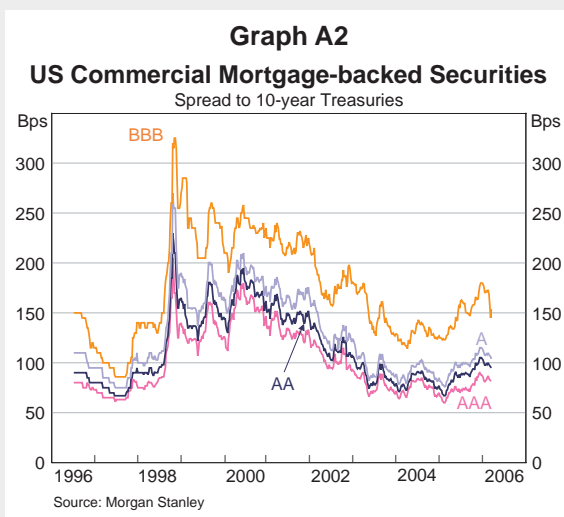
sector, often against the backdrop of generally subdued corporate demand for debt. For example, over 2005, bank lending for commercial property in the United States grew by 17 per cent, while in the United Kingdom it grew by 18 per cent, continuing the high rates of growth seen in recent years. This strong growth has attracted the attention of prudential supervisors. Earlier this year, the US federal bank and thrift regulatory agencies issued draft guidelines to institutions on sound risk management practices for commercial property loans, noting that some institutions had high and increasing concentrations of loans where repayment is primarily dependent on sources such as rental income, the sale of the property or refinancing. In the United Kingdom, the Financial Services Authority has noted the rapid growth in commercial property lending and associated risks on numerous occasions in recent years.

There has also been an increase in the financing of commercial property through capital markets. Industry data show that in 2005 issuance of commercial mortgage-backed securities (CMBS) in the United States was around US\$170 billion, an 82 per cent increase over the previous year. Strong activity is also evident in Europe, where around US\$56 billion of CMBS were issued in 2005, with around three quarters of this amount issued in the United Kingdom. Credit spreads of US CMBS to 10-year Treasuries remain low by historical standards, notwithstanding some widening over the past year reflecting increased issuance and investor concerns over the higher leverage and lower credit support levels in recent issues of CMBS (Graph A2).

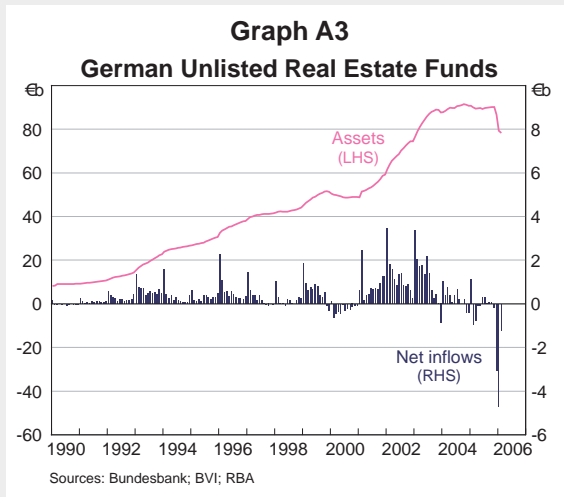
There has also been strong growth in commercial real estate collateralised debt obligations (CDOs): in the United States more than US\$21 billion in real estate CDOs were issued in 2005 compared with US\$8.4 billion in 2004.

The increasing supply of CMBS and CDOs, with a range of subordination, has broadened the investor base in real estate debt markets and reduced the commercial property sector's dependence on bank financing. It has also helped increase market scrutiny of the commercial property sector. These are generally favourable developments from a financial stability perspective.

Investor interest in commercial property may increase further, with the United Kingdom, Germany and several other countries planning legislative changes to encourage the development of the listed property trust sector. The changes will promote trust structures along the lines of US real estate investment trusts, which are similar to listed property trusts in Australia in that holdings can be actively traded on an exchange. In the United Kingdom, for example, subdued



secondary trading of the existing listed property trusts has, to date, limited their appeal to small investors.



Some of the risks associated with commercial property and, in particular, unlisted unit trust structures, were recently highlighted in Germany, where the commercial property market has been weak. Difficulties emerged when a number of unlisted retail property trusts experienced a heavy flow of unit redemptions, as investors attempted to access funds before a feared downward revaluation of the trusts' assets (Graph A3). The redemptions exposed the substantial maturity mismatch between the liabilities and

assets of the trusts, with investors' highly liquid claims on the trusts backed primarily by relatively illiquid real estate. The run prompted a freeze on redemptions in several funds, a statement of support by a major bank associated with one of the trusts, as well as a statement by German regulatory agencies expressing confidence in the long-term prospects for the industry. ❖