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FINANCIAL SERVICES

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Banks should practice active, holistic, and integrated real estate management—and they should do it now

At a glance

1

Opportunities and risks

- As banks increased their presence in real estate, they also increased their exposure to risk.
- They should strike the right balance between mitigating those risks and capitalizing on the opportunities in their real estate assets.
- Forward-looking banks are launching initiatives like new processes, new roles, and new business and operating models.
- These initiatives can be useful, but they may not be enough to help banks manage their real estate dealings.

2

Building an integrated strategy

- Banks should craft holistic, active, and integrated banking and real estate business strategies.
- They can start by identifying their biggest potential risks and the most promising opportunities and deciding how best to manage them.
- Next, they can build a case for creating a business unit or operating model dedicated to that overarching task.
- Critically, they can also designate a chief real estate office to set the top-down real estate strategy.

Banking and real estate have had a lengthy relationship—one with deep and complex roots. In most countries, certainly those in Continental Europe, retail and commercial banks are the ultimate owners of most of the assets in the real estate sector. This is undeniable if we define ownership in broad terms.

For instance, banks' real estate assets might include proprietary instrumental assets and owned assets related to leasing contracts. They might also include performing mortgages' collateral, assets related to development projects, collateral for nonperforming loans, and those in which banks have invested as part of their insurance and wealth management businesses.

As banks increased their presence in real estate, they also increased their exposure to risk. Indeed, real estate risk has been the main culprit behind banks' failures in recent history—even if few regulators and risk managers would mention the connection. Plentiful notorious cases have shown the link, starting with the Lehman Brothers debacle back in October 2008.

When it comes to the real estate cycle, banks operate almost like hedge funds, with long positions on the cycles. It's true that their exposure to the risks associated with their real estate assets is significant. But that risk derives mostly from property that banks don't directly own but, rather, use as collateral for their lending businesses.

It may look like they have a call on the underlying real estate asset, yet when the real estate cycle crashes, banks end up having "sold a put" to borrowers—primarily real estate developers but also retail traders. Such borrowers may have bought real estate assets with limited equities, may have rented them out to cover the mortgage interest rate, and are waiting for the assets' market values to increase—with the goal of

FIGURE 1: REAL ESTATE ASSETS POWERFULLY INFLUENCE BANKS' FINANCIAL PERFORMANCE

		Starting situation		Real estate (RE) market contraction: -10%		
		Initial assets (Base: 100)	RE value (Base: 100)	RE value (Base: 100)	Correlation ratio hypothesis*	RE value (Base: 100)
Tangible assets	Mortgage	8.5	19	17	1:5	8.1
Tangible assets	Loans to developers	5.8	12	11	1:2	5.2
Tangible assets	Property assets/leasing	2.1	4	3	1:2	2.0
Tangible assets	Nonperforming loans	1.9	4	3	1:3	1.7
	(Subtotal, bracketed)	18.3				17.0
Tangible assets	Other tangible assets	80.5	–	–	–	80.5
Intangible assets		1.2	–	–	–	1.2
Total assets		100.0	38	34		98.7
Liabilities		96.0	–	–	–	96.0
Tangible equity		4.0	–	–	–	2.7
Liabilities and equity		100.0	–	–	–	98.7
Tangible equity		4.0	4.0% ratio	2.7	2.8% ratio	
Tangible assets		98.8		97.5		

A 10% contraction in the RE market can imply a 20% to 30% decrease in a bank's regulatory capital

Note: Hypothesis is on the correlation between asset value and real estate collateral value.
Source: AlixPartners analysis

flipping the asset—often in a matter of months. If an asset's value doesn't increase—or if it decreases—the borrower offloads the asset to the bank because the loss in market value is greater than the equity put to buy the asset.

Banks' considerable exposure in the area of real estate assets translates into volatility in banks' financial assets' mark-to-market valuations. In fact, a 10% contraction in the value of the real estate sector overall could imply a 20 to 30% drop in a bank's regulatory capital if the bank elects to value its entire asset portfolio by taking a mark-to-market approach (figure 1). Shrinking regulatory capital would then put a bank in danger of insolvency if it's unable to raise further needed capital.

That inherent imbalance can't be sustained forever. If banks want to avoid a new day of reckoning in their real estate dealings, they'll have to strike the right balance between mitigating the risks and capitalizing on the opportunities inherent in those assets. To do that, they'll have to deepen their understanding of the forces that fuel the real estate cycle, that determine single-asset valuation, and that affect their lending portfolios' diversifications, including the impacts of real estate risk.

LAUNCHING NEW INITIATIVES

Forward-thinking banks have begun launching initiatives aimed at better managing their real estate assets. Such initiatives can be in the forms of new processes, new roles, and new business and operating models. For instance, some banks have created maps depicting their real estate exposure. They gauge that exposure on owned assets used in their operations—such as headquarters and branch facilities; on leased assets; on assets used as collateral for retail and corporate mortgages or for nonrecourse special-purpose-vehicle brownfield or greenfield developments; and on real estate in their assurance and asset management portfolios.

Other banks have developed dashboards comparing overall yields they have achieved on real estate assets and the related costs—such as capital expenditure, operating expenses, taxes, and opportunity costs. By comparing yields and costs, they can make more-informed strategic decisions. For example, these banks can determine how to increase rents paid by the best-available users of a real estate asset and thereby boost their yields attained on capital.

Consider the following additional examples of initiatives that some banks are exploring.

- **Active real estate management.** Banks are developing dynamic business plans for their main real estate assets and projects linked to real estate developers. They define related key performance indicators (KPIs)—such as rent earned per square meter compared with cost of the building—and early warning signals, such as when a KPI falls below a certain threshold. The KPIs are depicted on a dashboard that monitors and proactively manages risk, starting with assessment of the value of the real estate asset being developed.
- **Real estate agency.** Some banks are setting up real estate intermediation agencies that work online such as by posting assets for sale on dedicated Web sites and off-line—for example, by using banks' branches and salespeople to promote the same assets for sale. Such agencies seek to increase the liquidity of repossessed assets, real estate development projects, and real estate owned or rented by the bank's retail and corporate clients. In doing so, they help bring in further commissions from this intermediation business.
- **Real-estate-owned company.** Banks are setting up real-estate-owned companies to optimize the repossession of collateral from defaulted loans from banking or leasing books. The company might also develop asset, property, and facility management capabilities. And as part of the banking group, the company could offer those capabilities as services to real estate assets owned or in use by the bank. It could also offer them to its small and medium-size clients in return for commissions.
- **Active space management.** Using this approach, a bank tries to optimize the use of its owned real estate assets. For instance, it might seek to minimize the rents it pays on assets it's leasing, or it might seek to maximize the rents earned on assets it owns. It could also strive to boost revenues from the use of real estate assets supporting its distribution business. Examples are enhancement of sales generated per square meter (weighed at market price) of the bank's branches. To do that, the bank would have to set up real estate distribution assets in the right locations and then monitor them continually because customer behaviors change over time.
- **Real-estate-portfolio allocation.** A bank aims to tailor its lending portfolio to the real estate cycle. Toward that end, it defines a hierarchy of

risk factors to be considered, such as criteria for collateral for loans, including the use, location, and technical specifications of an asset. A variance–covariance matrix can help by comparing how each diverse real estate asset in a bank's portfolio is behaving in response to changes in market dynamics. That approach can reveal risks related to overconcentration in a bank's real estate portfolio. For instance, if a bank has invested too heavily in, say, hotel buildings in one location, it faces high risks if something happens to discourage tourism in that location. The ultimate goal is to maximize the bank's diversification on each risk factor, with the accessory goal of optimizing its return on risk-adjusted capital.

- **Real estate x-cycle analysis.** Under this initiative, a bank analyzes trends for each stage of the real estate cycle at the country and regional levels. It conducts the analysis at a macroeconomic level—for instance, by assessing trends in available income and lending supply. And it considers the microeconomic level—for example, by mining unstructured data such as supply-and-demand trends and, to track real-time market changes for certain locations, the number of likes from the Web.
- **Real estate business plan assessment.** A bank applies a rigorous methodology to develop an IFRS 9–compliant full revaluation of its real estate collateral. The process might include nonperforming exposures (NPEs), nonperforming loans (NPLs), or performing exposures and loans. The bank integrates the resulting state-of-the-art appraisals into a business plan. It also conducts dynamic simulations, creates stress-test scenarios of the portfolio's value, and considers the best strategies for reducing risky concentration and tail risks (those associated with worst-case scenarios) so as to limit downside risk in the portfolio.
- **Real estate joint venture and deconsolidation structure.** A bank creates one or more special-purpose vehicles through which it can contribute a small number—or a larger portfolio—of real-estate-development loans. It then seeks to forge partnerships with industrial counterparts that have deep knowledge of and management expertise in the real estate sector. It also seeks to partner with financial institutions that can provide new finance that will sustain the selected management strategy for the portfolio. Ideally, those moves will enable the bank to deconsolidate this.
- **Real estate dashboard.** A bank creates a dashboard that integrates a number of KPIs and other information on its real estate exposure. Executives can use the dashboard to more effectively manage workouts and to monitor real estate collateral for NPLs as well as continue managing the performing portfolio. The dashboard gives an overview of key aspects of the bank's real estate assets, which may include geographic distribution, collection agencies' effectiveness, the bank's repossession activity, and its resale values compared with the latest real-estate-market trends.
- **Integrated real-estate-services company.** Banks that implement this kind of initiative consolidate most of the aforementioned moves into newly created—or mission-extended, existing—companies. The companies act as real estate centers of excellence for the banks. They lead the bank's run-down, or liquidation, strategy and may optimize the overall risk/return profile coming from the bank's exposure to the real estate sector. In some cases, the companies are created from the banks' internal real estate units; in others, from previous, so-called bad-bank structures once most of the workout process is complete. In other cases, the companies are created as new so as to limit the influence of legacy structures.

CRAFTING AN INTEGRATED BANKING AND REAL ESTATE STRATEGY

The initiatives previously described can be very useful. But they are not themselves enough to help banks better manage the risks and exploit the opportunities inherent in their real estate dealings. That's because the initiatives represent a piecemeal approach, which can have only limited impact on a bank's overall strategy.

To overcome those limitations, banks should craft holistic, active, and integrated banking and real estate business strategies. Then they should build the governance and organizational structures required to execute the strategies. By achieving that, banks could gain important competitive advantages. For one thing, they can better address their real-estate-related risk exposure and potential diversification from an ex ante perspective (asset allocation and related underwriting and pricing on new loans) and from an ex post angle (NPEs and NPLs). They could also boost the productivity—and therefore the net margin—of their owned real estate assets and improve yields on repossessed assets, hence heightening their exit values. Finally, they can unlock fresh sources of revenue—such as commissions—coming from new businesses, mostly intermediation or advisory. They might do that by capitalizing on cross-selling opportunities that arise from the completion of real-

estate-development projects. Or they might develop trading activities for those assets. The achievements can help banks pursue other essential objectives as well. For example, they could generate regulatory capital and reduce value at risk and economic capital. They can also define lending prices that better reflect a bank's inherent real estate risk. That helps reduce and stabilize the cost of risk in the bank's lending portfolio as well as decrease the costs of the bank's owned and repossessed real estate assets.

To define an integrated banking and real estate strategy, bank executives can start by diagnosing their real-estate-related exposure. They should identify their bank's biggest potential risks and the most-promising opportunities and then determine how to best address both of them by using levers available in their market. Next, they can build the business case for creating a business unit, a service company, or an operating model dedicated to this overarching task. They should then specify the governance, organizational structures, and processes they'll need in place to fulfill their mission. The executives should also articulate the objectives that the new structure or model will be responsible for attaining. Those objectives will vary depending on the bank's individual circumstances and specific challenges. The objectives might include enhancing commissions and net margins from the bank's core business, making the lending portfolio's cost of risk less volatile, or generating regulatory capital.

To execute the integrated banking and real estate strategy a bank has defined, we recommend creating new types of governance and organizational structures. Next, we take a closer look at two especially powerful such structures.

SET UP A CHIEF REAL ESTATE OFFICE AS A SERVICE CENTER

Designate a chief real estate office to set the top-down real estate strategy for your bank, including setting the overall target-risk-and-return profile for the bank's real estate and related capital allocation. The office will also help define future lending policies such as target loans portfolio allocation and will provide inputs to the chief lending officer on the best allocation and diversification of real estate collateral. In addition, the chief real estate office will:

- Define and monitor current direct and indirect real estate exposure risk. Eventually, it will move the bank toward taking a quasi-mark-to-market perspective in order to better manage its overall risk/return profile on the real estate sector.
- Develop new real estate indexes that draw on structured and unstructured data coming from the Web and that use machine learning and artificial intelligence applications to better understand real-estate-market trends (figure 2).
- Define fair IFRS 9 value of the bank's real estate assets for valuing new or existing real estate collateral.

FIGURE 2: STRUCTURED AND UNSTRUCTURED DATA CAN HELP BANKS BETTER UNDERSTAND REAL ESTATE MARKET TRENDS

Source: AlixPartners

- Define and manage internal service-level agreements for owned assets and for the property and facility management services the bank offers.
- Develop and own the overall real estate dashboard, tracking net yield from owned real estate assets.
- Help coordinate the cross-selling of other products and services with the real estate integrated-services company.

CREATE A REAL ESTATE INTEGRATED-SERVICES COMPANY AS A PROFIT CENTER

Your real estate integrated-services (REIS) company will own repossessed real estate collateral and the equity stakes of property companies and projects coming out of debt conversion. The company should also develop and execute an active management strategy by working with industry experts to lead real-estate-development projects. In addition, the company should craft and execute a sales strategy, and to that end, it will work with business-to-business brokers or through the bank's branch network, paying a share of sales commissions to the bank's retail division. The company might also implement ad hoc initiatives such as setting up and launching real estate investment trusts jointly with insurance or asset manager partners or as part of the bank's wealth management business.

The REIS company might also take responsibility for strengthening the bank's real estate capabilities internally. To build and deploy skills not available in-house, it might develop an ecosystem of partnerships with players that have specific real estate expertise and could help the bank develop those capabilities either at home or abroad (figure 3). In the longer term, once it's done most of the work required for the bank's parent company, the REIS company could also offer asset, property, and facility management services to the open market as well as to the bank's clients. And it might negotiate joint ventures with the bank's other business units or establish joint ventures with international operators acting in the real estate sector.

Banks' long-standing marriage to real estate has presented both opportunities and risks. And as the relationship has deepened, the risk has intensified. To avoid a day of reckoning that would resemble the rash of bank failures we saw at the start of the great global recession, banks should take a more disciplined approach to the management of their real estate dealings. Banks that integrate their banking and real estate business strategies—and that create the right governance and organizational structures to execute those strategies—will stand the best chance of meeting the imperative. A

FIGURE 3: BANKS CAN PARTNER WITH EXTERNAL EXPERTS TO BUILD REAL-ESTATE-SERVICE SKILLS (ILLUSTRATIVE)

	Asset types					
Real estate services	Residential	Commercial	Large single-name property	Geography 1	Geography 2	...
Agency						
Property management						
Valuation						
Asset management						
Consulting and research						
Property development						
...						

- Forge partnerships after your REIS company is set up and operational.
- Consider defining partnerships at the service level, the typology level, or both.
- Let your strategic objectives and asset typology drive your choices of legal, commercial, and industrial structures such as REITS, joint ventures, and business-process-outsourcing arrangements.

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