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An assessment of vulnerabilities in the South African commercial real estate sector and the financial stability implications[2]

Abstract

This paper explores the nexus between the South African commercial real estate (CRE) sector and the financial system, with a focus on potential vulnerabilities, their interconnectedness and the implications for financial stability. The paper finds that since the COVID-19 impact, financial imbalances in the domestic CRE sector have grown substantially and are differentiated across segments. Climate change has further increased existing CRE vulnerabilities through several channels. The banking sector's declining exposure to the CRE sector in South Africa suggests an interesting dichotomy. On the one hand, limited exposures point to growing financing challenges for the CRE sector. On the other hand, it may suggest tightening lending standards in response to growing risks usually associated with the current prolonged and downward phase of the domestic CRE cycle. While investors may incur large financial losses in the event of market shocks, systemic risks appear limited due to the relatively low direct exposure of the financial system to the CRE sector. The paper also discusses policy measures that could effectively curb any emerging financial stability risks emanating from the sector.

JEL classification: G21, G23, G32
Key words: CRE, financial stability, interconnectedness, macroprudential policy, risks, vulnerabilities

1 Douw Boshoff is a research fellow contracted for the SARB's Commercial Real Estate project and a Research Associate at the Gordon Institute of Business Science.

2 The paper befitted from inputs and comments by external reviewers.

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1. Introduction

The South African commercial real estate (CRE)[3] sector has the potential to affect broader financial stability, due to its size, price movements that mirror the broader macro-financial picture and its heavy reliance on debt funding. The sector is highly interconnected with the financial system through financial exposures and with the real economy, through its related economic activities. In addition, the global financial crisis of 2008 and the economic fallout in the aftermath of the COVID-19 pandemic proved that disorderly adjustment in the CRE sector can have adverse implications on the stability of the financial system. The International Monetary Fund's (IMF's) recent *Global Financial Stability Report*[4] highlights the growing importance of this sector to financial stability through several channels, including asset valuations and leverage. Globally, the debt losses from CRE were significant in past crises, underscoring the importance of understanding and managing the risks associated with the interconnectedness between the CRE sector and the financial sector (ESRB, 2018, IMF, 2023).

The COVID-19 shock caused significant disruptions and uncertainty globally, necessitating an in-depth analysis of the effects of the crisis on the CRE sector. These disruptions include structural changes relating to hybrid working models and e-commerce, which could potentially threaten financial stability (Deghi, Natalucci and Qureshi, 2022). While the sector is unlikely to trigger a financial crisis on its own, it represents an important source of systemic risk (ESRB, 2018). This paper thus seeks to explore the following key themes. Firstly, the paper identifies CRE vulnerabilities and key channels through which domestic financial stability is impacted post COVID-19 (interacting with recent shocks stemming from the higher-for-longer interest rate environment). Secondly, it assesses the extent of the interconnectedness between the CRE sector and the wider financial system. Lastly, this work recommends macroprudential policy responses that could be considered if vulnerabilities in the CRE sector escalate to the point where they threaten financial stability.

3 There is no universal definition of commercial real estate, neither in South Africa nor from international professional bodies. However, it is generally understood as real estate used for business purposes, i.e. non-residential properties, within urban centres (and not relating to agricultural use).

4 See https://www.imf.org/en/Publications/GFSR/Issues/2024/04/16/global-financial-stability-report-april-2024.

The rest of the paper is structured as follows: Section 2 discusses the theoretical framework employed to assess CRE-related vulnerabilities. Section 3 discusses the size and structure of the domestic CRE sector. Section 4 analyses the global and domestic trends and related vulnerabilities. Section 5 examines the interconnectedness between the domestic CRE sector and the financial system. Section 6 explores policy recommendations to enhance the financial system's resilience from negative spillovers from the CRE sector. Section 7 concludes by providing a summary of the key findings.

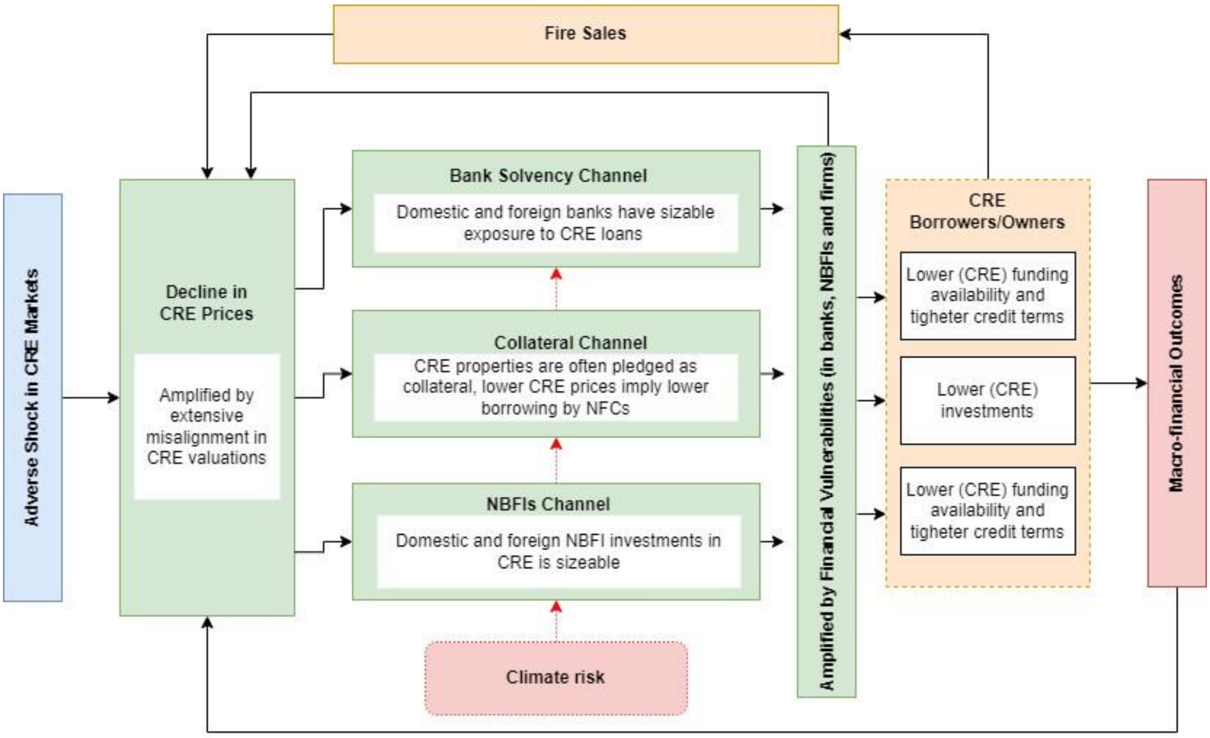
2. Theoretical framework to assess CRE-related vulnerabilities

Several studies find that vulnerabilities in the CRE sector stem from various key factors, such as property valuations driven by macroeconomic dynamics and the financial health of lenders and borrowers. Misaligned prices can signal a prospective decline in property values, further aggravated by prevailing financial instabilities (Deghi, Mok and Tsuruga, 2021). Excessive leverage can instigate a cycle of escalating credit and asset prices. In the event of a market downturn, this could severely affect borrowers, leading to a domino effect of defaults causing banks to suffer losses, eroding their capital buffers, and potentially reducing lending.

The CRE sector is susceptible to both sector-specific and economy-wide shocks. Sector-specific shocks could result in a decline in the demand for certain CRE segments, while macroeconomic shocks, such as a collapse in aggregate demand induced by the pandemic, or an increase in risk aversion (financial shock), could exert downward pressure on CRE prices. As observed during the period of higher interest rates, shocks have the potential to amplify pre-existing vulnerabilities, worsening the macro-financial outcomes.

The development and calibration of potential macroprudential policy measures requires a comprehensive assessment of the channels through which financial stability may be impacted. Figure 1 presents a conceptual framework of the transmission channels of adverse shocks to the CRE sector on macro-financial outcomes. The key transmission channels are discussed below.

Figure 1: CRE and financial stability: Transmission channels



Source: Adapted from the IMF (2021)

2.1 Channels of transmission of CRE vulnerabilities

2.1.1 Bank solvency channel

Banks are exposed to credit risk through their portfolios of CRE loans, as well as market risks associated with their holdings of commercial mortgage-backed securities[5] (CMBS). A downturn in the CRE market negatively impacts the balance sheet and credit quality of borrowers, increasing the likelihood of default. The spillovers emanating from defaults by borrowers include banks incurring losses and deteriorating capital positions, resulting in lower credit supply to the sector and the broader economy.

5 Commercial mortgage-backed securities (CMBS) are fixed-income investments secured mortgages on commercial properties and are particularly relevant in the US. CMBS can provide liquidity to real estate investors and commercial lenders. Also see https://cdn.janushenderson.com/webdocs/Securitized%2520primer_Commercial%2520Mortgage-Backed%2520Securities%2520%28CMBS%29.pdf.

2.1.2 Collateral channel

Collateral values tend to fall during a CRE market downturn, limiting lending to the sector, which can weigh on the overall growth outlook of the economy. This channel relates to the pledging of commercial property as collateral by borrowers (i.e., nonfinancial corporations) to acquire credit from financial institutions. The IMF (2021) notes that the collateral channel could also reinforce the bank solvency channel - lower collateral values increase the loan-to-value (LTV) ratios of existing CRE loans. This lowers CRE prices and exposes banks to losses when underlying assets are used as collateral – by increasing banks' losses given default (LGDs). This could raise the value of banks' risk-weighted assets (RWAs) while eroding their regulatory capital ratios.

2.1.3 NBFI channel

The decline in CRE prices has negative implications for CRE debt and equity investments by non-bank financial intermediaries (NBFI) such as insurers, pension funds, and investment funds due to valuation effects. Additionally, real estate investment trusts (REITs) (listed, unlisted, equity or mortgage) and property funds (open or close-ended) are generally exposed to CRE. Lower investment values may impact financial stability as investors are less willing or able to provide new financing due to solvency constraints, in the case of insurers. Investment funds are likely to incur redemption pressures from end investors in such a scenario, triggering fire sales of CRE assets. The CRE sector is inherently highly illiquid, and interacting with large maturity mismatches of property investment funds has the potential to amplify existing vulnerabilities. In addition, a sharp correction in prices could amplify the bank solvency channel, as some NBFIs (such as property investment funds) are leveraged and rely on bank debt financing (IMF, 2022, IMF, 2023).

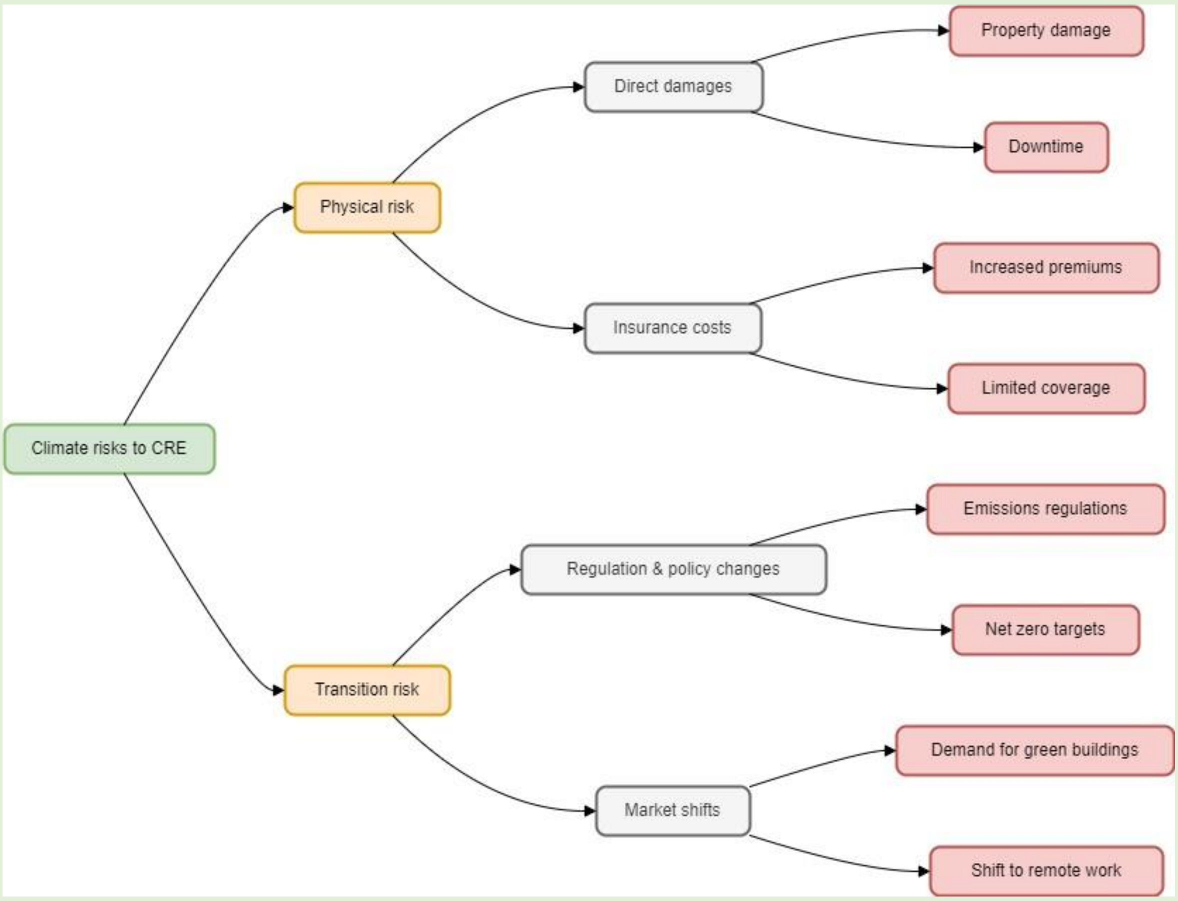
2.1.4 Climate change risk channel

Climate risks and the CRE loan market have many points of intersection that require both banks and NBFIs to recalibrate their risk assessment frameworks. As such, an emerging area of concern incorporated in this paper relates to the impact of climate change on the CRE sector (Box 1). It is crucial to consider both the current and future impacts of climate change on commercial real estate valuations, particularly in areas prone to natural disasters. Additionally, attention must be given to the potential spillover effects on the financial system, given its significant exposure to CRE.

Box 1: Climate-related vulnerabilities to the CRE sector

Climate risk is rapidly emerging as a significant factor in CRE literature, as its consequences directly impact the condition and value of properties. Globally, the increasing frequency and intensity of extreme temperatures, flooding and wildfires have negatively weighed on the cashflows generated by CRE assets. Insurers are gradually incurring higher claims ratios due to the growing incidences of acute weather events. These developments have further worsened the vulnerability of the sector post the COVID-19 pandemic. The consideration of physical and transition risks has become critical in pricing in the potential impact of climate change on the sector (Figure 2) and to minimize spillovers to the financial sector.

Figure 2: Impact of climate change on the CRE sector



Source: Authors' formulation

Physical risks

Over time, buildings have become increasingly susceptible to physical climate risks, which have intensified in recent years. Extreme weather events can negatively impact a building's financial performance, making it uninhabitable and requiring costly restoration. The values of properties located in areas prone to such acute weather events significantly affect financial institutions, mainly through the solvency and collateral channels. Additionally, climate risks tend to amplify the inherent maturity mismatch risks in the financial sector. To limit losses from climate risk, insurance firms may resort to increasing premiums (partly due to increasing reinsurance costs) or limit the coverage in certain disaster-prone areas, triggering financial stability concerns IFC (2019).

Specific to South Africa (SA), the physical risks of climate change manifest mainly through the destruction of property caused by the increasing frequency and intensity of storm-related events, such as floods, hail, and high winds, as well as rising temperatures and water scarcity. Examples of recent climate events include the severe drought experienced in the Western Cape, which severely limited urban water supplies between 2015 and 2018. Water scarcity is expected to worsen, especially in the central, northern, and southwestern regions of the country. Flood risks are also rising, particularly in KwaZulu-Natal, the Eastern Cape, and Limpopo, with catastrophic flood events like the 2022 Durban floods causing significant damage to property and bulk infrastructure. Coastal cities like Cape Town, Durban, and Port Elizabeth are also vulnerable to rising sea levels,[6] which threatens infrastructure over the long term (Hattingh, 2022).

Transition risks

Drivers of transition risks include, *inter alia*, higher operating costs due to the pricing-in of carbon emissions, market effects, technological advancement, legal liabilities, energy efficiency and other regulations. These factors could create reputational risks that could impact property values. As low-carbon adaption in real estate becomes embedded in policy and law, there is an increasing risk of asset write-downs and assets becoming stranded[7] if market expectations and regulatory requirements are not met. A study by Ferentinos, Gibberd and Guin (2021) notes that carbon-intensive properties have seen reductions in value after climate policies were enacted in the United Kingdom. Given that almost 40% of global greenhouse gas emissions come from real estate, either directly or indirectly, this sector is particularly vulnerable to risks related to the green agenda. These risks have given credence to the growing need for *green buildings*. According to the International Finance Corporation (IFC 2019), green buildings are more efficient than traditional ones and over time lower operating costs, increase revenues, and reduce exposure to physical (and transition risks).

6 https://climateknowledgeportal.worldbank.org/sites/default/files/country-profiles/15932-WB_South%20Africa%20Country%20Profile-WEB.pdf

7 Stranded assets refer to assets that have become or are projected to become obsolete, uneconomical, or non-productive before the end of their expected useful life.

Transitioning to more environmentally sustainable CRE may require significant additional financial investment. Some of the costs include complying with new regulatory and environmental laws, adopting economic, social and governance (ESG) frameworks, and adapting to shifts in market demand. While building green can escalate construction costs by between 0.5% to 12%, operational costs may be lowered by up to 31% and occupancy rates can improve by up to 23% (IFC, 2019). To achieve sustainability, these initial costs of transitioning may exert some financial stress on the CRE sector in the short to medium term.

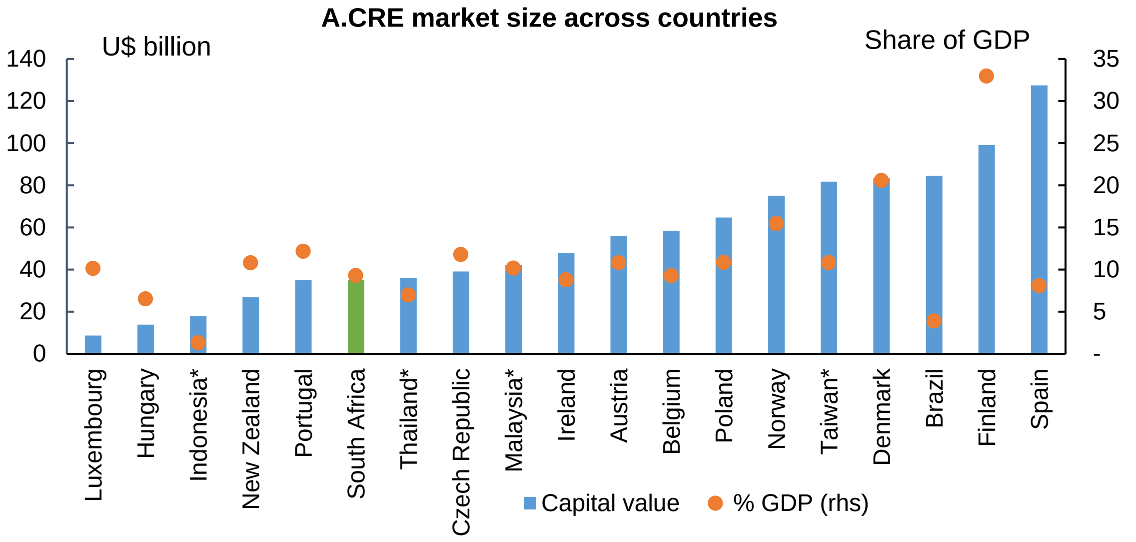
Domestically, the green agenda is gaining momentum in both the finance and commercial real estate sectors. Recent developments in this regard include the parliamentary approval of the Climate Change Bill in April 2024. The Bill, *inter alia*, provides a blueprint for carbon emissions targeting by sector as well as mechanisms to finance the broader climate change response. Similarly, the JSE now mandates all listed companies to disclose the impact of climate change and how transitioning to net zero will impact their business and how in turn, their business will impact on the wider environment and society.[8] This direct link between corporates and the green agenda will drive up the demand for green commercial buildings to own or rent, with the IFC (2019) estimating that South Africa's green building demand to be at around USD7 billion between 2016 and 2030.

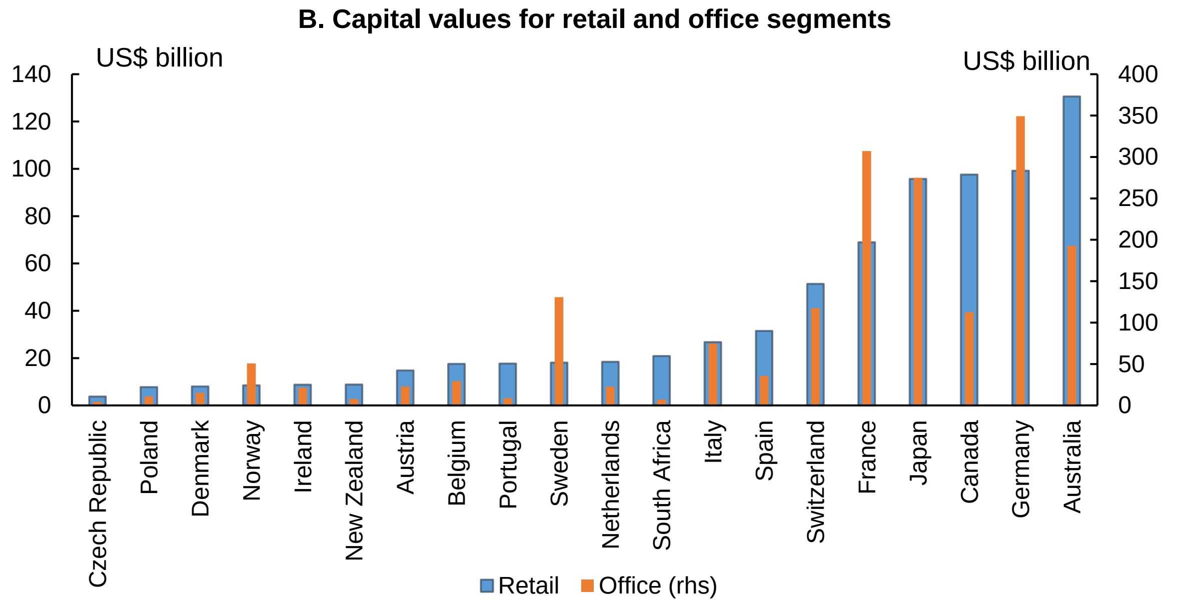
3. The size and structure of the South African CRE sector

The domestic CRE market is sizable relative to selected comparable jurisdictions (Figure 3A). Recent data shows that the South African market size is comparable to advanced economies (AEs) such as New Zealand, Portugal, and the Czech Republic. When considering the retail segment, the largest segment domestically, SA ranks higher than several AEs tracked by MSCI, while the office sector, is among the smallest (Figure 3B).

[8] JSE climate disclosures are aligned with the International Sustainability Standards Board (ISSB), which is informed by the TCFD recommendations, and the King IV Guidance Paper on Responsibilities of Governing Bodies in Responding to Climate Change.

Figure 3: CRE market size across countries in 2023





* Asia Pacific Accreditation Cooperation (APAC) estimates

Source: MSCI, IMF/Haver Analytics

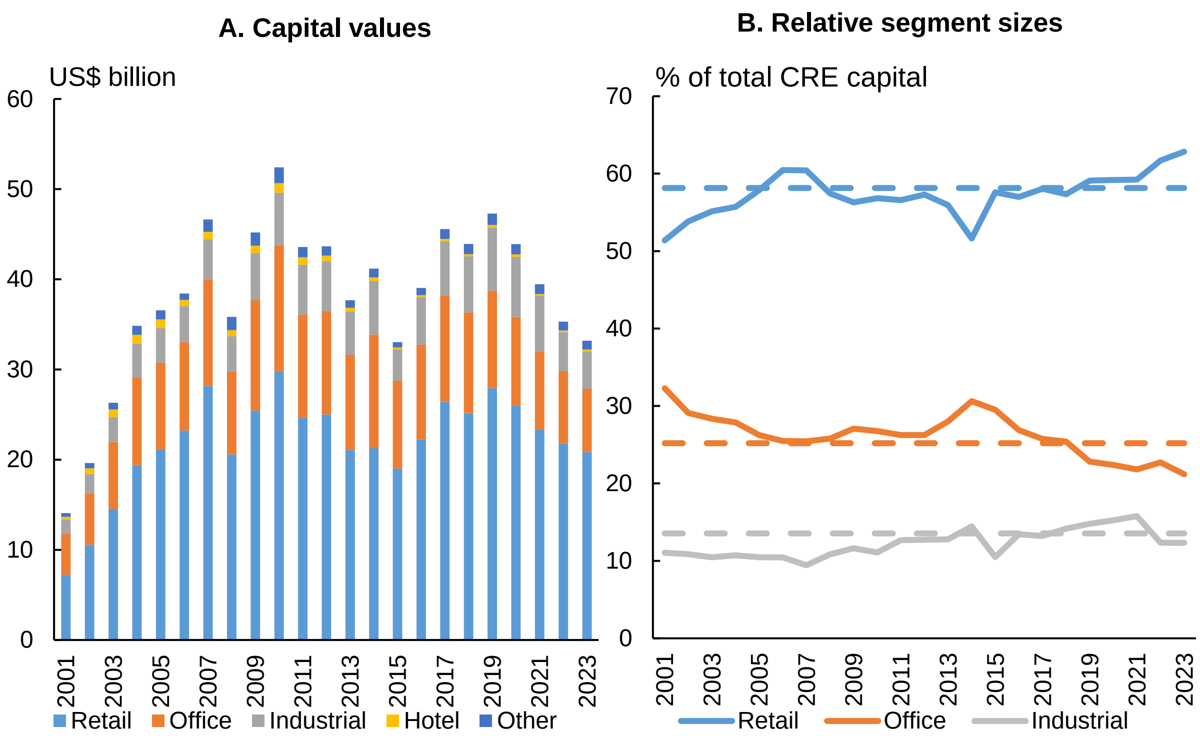
The total nominal value of domestic CRE assets grew substantially[9] between 2001 and 2010, mainly buoyed by the retail and office segments (Figure 4A). The CRE asset values recovered from the effects of the global financial crisis (GFC), largely supported by the economic activity (including construction) related to the 2010 World Cup. The impact of the COVID-19 pandemic is noted beyond 2020 and asset

9 It grew by 3.7 times in this period.

values have almost retreated to GFC levels. Since 2020, the office segment has been the worst affected.

Segmentation by capital values as a share of the total CRE industry shows the retail segment as the largest. While the retail segment's capital is declining in nominal terms (Figure 4A), its share of total CRE capital grew post-pandemic from about 59% in 2020 to 63% in 2023 (Figure 4B). The downward trend for the office segment since 2014 points to a slow burn that commenced well before the COVID-19 shock. The industrial segment increased between 2016 and 2021, before reversing those gains in just one year, from 2021 to 2022.

Figure 4: Capital values of SA commercial real estate assets by segment



Note: The dashed line in Figure 3B denotes the 10-year average for the segments' shares to total CRE capital.

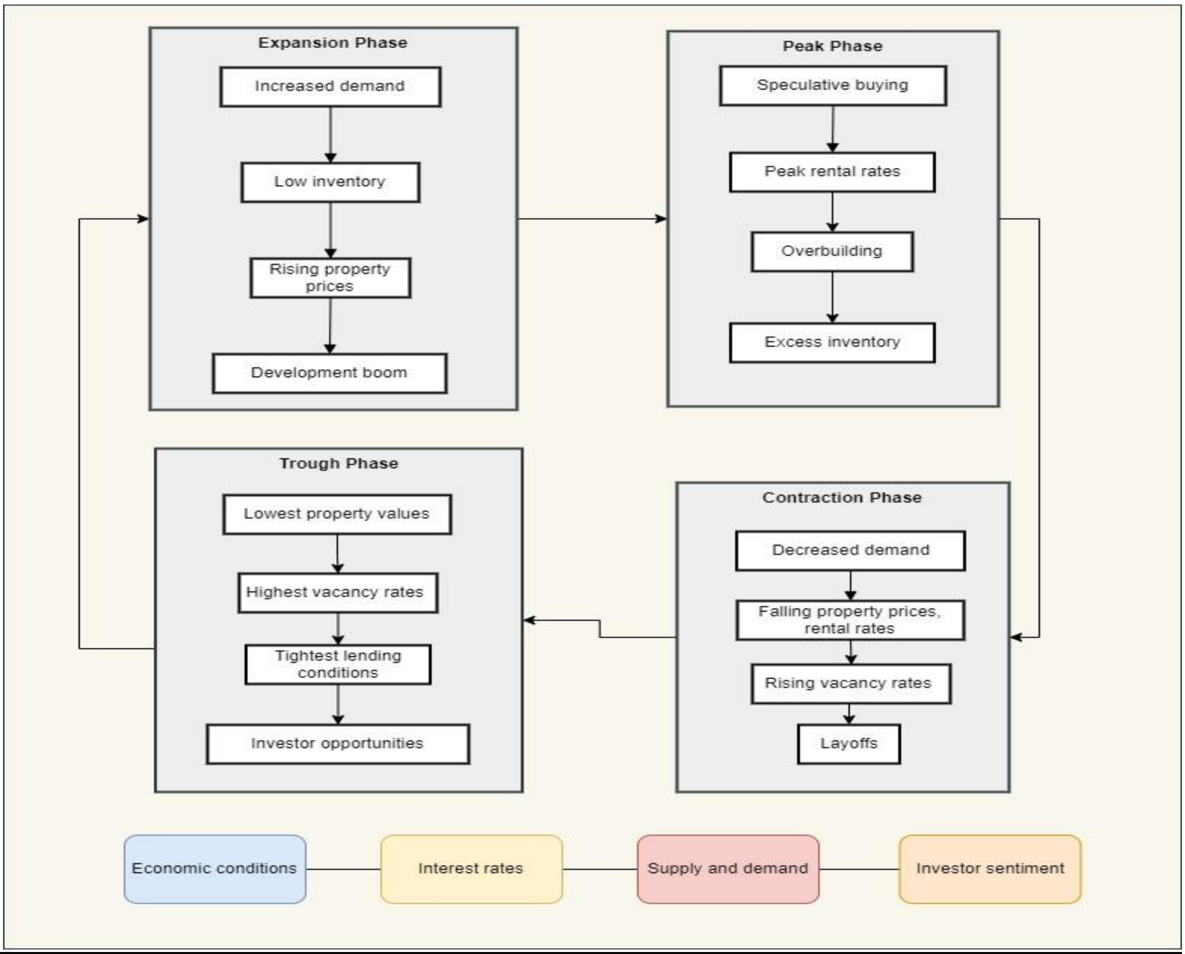
Source: MSCI

4. Analysis of the CRE sector and related vulnerabilities

Adverse developments in the CRE sector may trigger a systemic impact on the financial system and the real economy through direct and indirect channels

(ESRB, 2023). Due to the interconnected nature of the global CRE sector through the financial channel, it is important to analyse both global and domestic dynamics and trends. It is also crucial to note that the CRE sector operates in cycles and is influenced by a range of factors such as economic conditions and investor sentiment, among others (Figure 5). CRE exposure is a critical risk factor that can contribute to stress in the banking sector, as observed during the recent regional United States (US) banking crises. This stress could lead to negative spillover effects on the real economy—such as through its impact on the construction sector—thereby aggravating a downturn. Notably, CRE cycles tend to have larger amplitudes than the overall economic cycle (ESRB, 2023). This section thus analyses vulnerabilities in the CRE sector following the conceptual framework discussed in Section 2. The analyses will include, *inter alia*, key global and domestic trends. The latter covers market activity, income, valuations, investment, and exposures of the financial system (banks and NBFIs).

Figure 5: CRE cycle

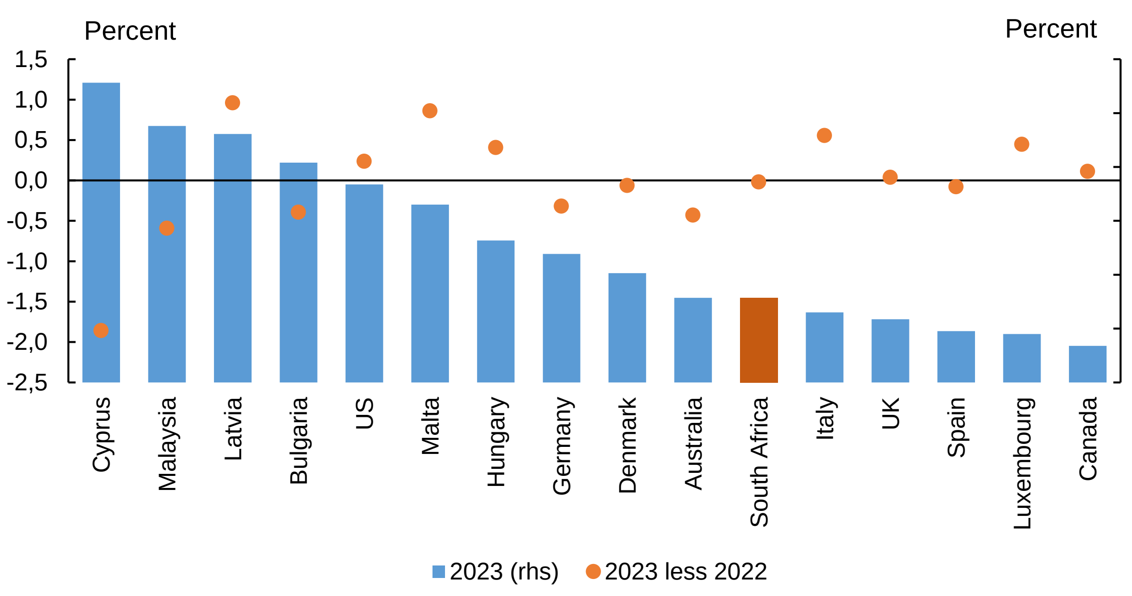


Source: Authors' formulation

4.1 Key global trends

Various macroeconomic factors affected the CRE sector globally. Prior to the COVID-19 pandemic, the global CRE sector was booming (Deghi et al., 2022). However, this trend reversed with the emergence of COVID-19, as CRE prices and transaction activity slumped (IMF, 2021). While many countries were beginning to recover from the COVID-19 crisis, Russia's invasion of Ukraine in 2022 triggered further economic disruptions, which contributed to the rise in global inflation. Initially, the rise in inflation was caused by increases in the prices of natural gas, oil, foodstuff and energy supply (English, Forbes and Ubide, 2024). In response, central banks worldwide raised interest rates, which have remained elevated, despite recent non-synchronized global policy easing. The challenges faced by the CRE sector stem from both cyclical and structural changes resulting from the COVID-19 pandemic, such as the shift to e-commerce, work from home (WFH) models, and the subsequent adoption of hybrid working arrangements. These shifts have led to significant vulnerabilities, particularly in the office segment.

Figure 6: Bank exposures to CRE

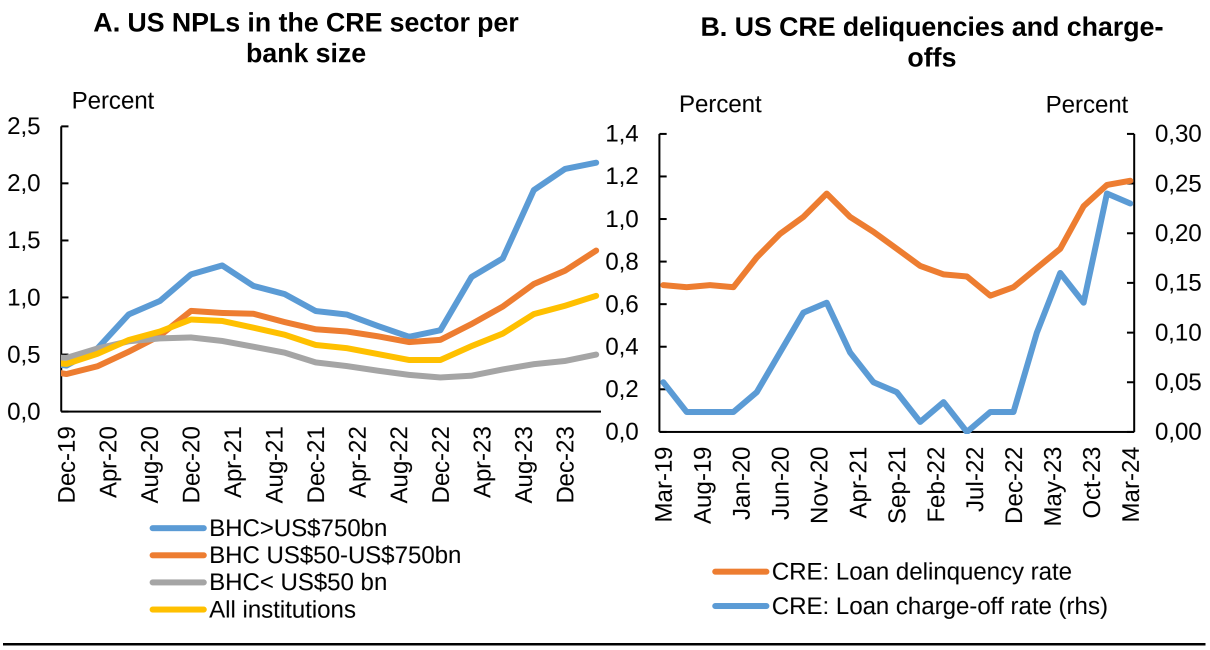


Source: IMF

The IMF's GFSR (2023) highlighted the increasing concerns about the state of the CRE market, which is facing challenges due to worsening economic conditions and higher funding costs. While bank exposures vary across countries, some banks hold significant CRE exposures (Figure 6). In the US, where the sector has experienced significant stress, small to mid-sized banks account for the majority of CRE lending. Therefore, any decline in asset quality would result in significant impacts on these banks' profits and willingness to lend. NBFIs also play a crucial role in the REITs sector, amplifying the ramifications of CRE market stress on financial stability and economic growth.

The recent tightening policy cycle by central banks has prompted closer scrutiny of CRE markets due to the potential impact of spillovers from the rising imbalances in the sector. In the US, high interest rates amplified some of the vulnerabilities already existing in the CRE sector (Figure 7A). The deterioration of US CRE assets across bank sizes and the increases in delinquencies and charge-offs[10] underscore the extent of pre-existing vulnerabilities in the sector (Figure 7B). The US regional banking crisis that ensued had limited cross-border spillovers due to timely and decisive action taken by authorities (Adrian, Abbas, Ramirez and Dionis, 2024).

Figure 7: US CRE asset quality



Note: In Panel A, BHC denotes a bank holding company.[11]
Source: Federal Reserve Bank of New York, Haver Analytics

[10] Charge-offs are the value of loans and leases removed from the books and charged against loss reserves. Charge-off rates are annualized, net of recoveries. Delinquent loans are those past due thirty days or more and still accruing interest as well as those in nonaccrual status. See: https://www.federalreserve.gov/releases/chargeoff/.

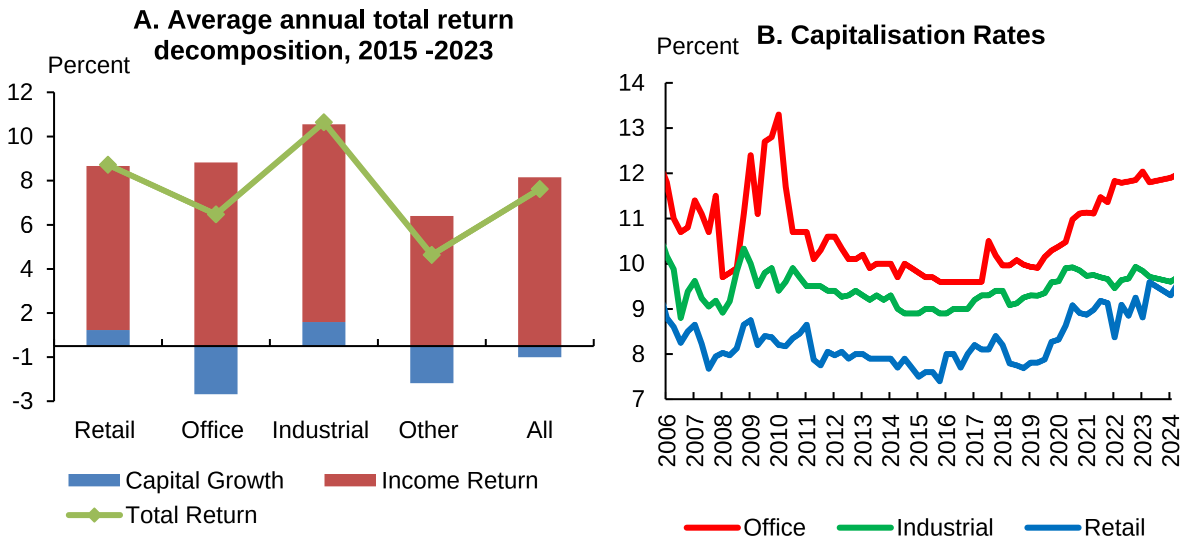
[11] The purpose of a BHC is to serve as a source of strength and capital for a subsidiary bank, diversify activities, and provide liquidity and a market for BHC common stock. See: https://www.atlantafed.org/-/media/documents/banking/supervision-and-regulation/become-a-member-bank/benefiting-from-the-flexibility-of-a-bank-holding-company-structure.pdf.

The key vulnerabilities in the CRE sector relate to the extent of overvaluation in prices and the balance sheet strength of lenders and borrowers. For instance, higher prices relative to those implied by economic fundamentals indicate a higher likelihood of a sharp price correction. The extent of the leverage or the maturity mismatch of assets and liabilities (balance sheet vulnerabilities), potentially creates a feedback loop between credit growth and asset price (IMF, 2021).

4.2 Domestic trends

Domestically, the CRE sector mirrors similar trends to those faced globally. In addition, it faces unique challenges which include a lack of consistent energy supply, water supply interruptions as well as escalating municipal rates and taxes. While significant investments have been made by the sector to address electricity supply, the other issues remain a concern. Moreover, physical risks stemming from climate change present a significant challenge for the CRE sector, impacting property values and increasing insurance costs (Clayton, Devaney, Sayce and Van de Wetering, 2021).

Figure 8: Total return and capitalisation rates



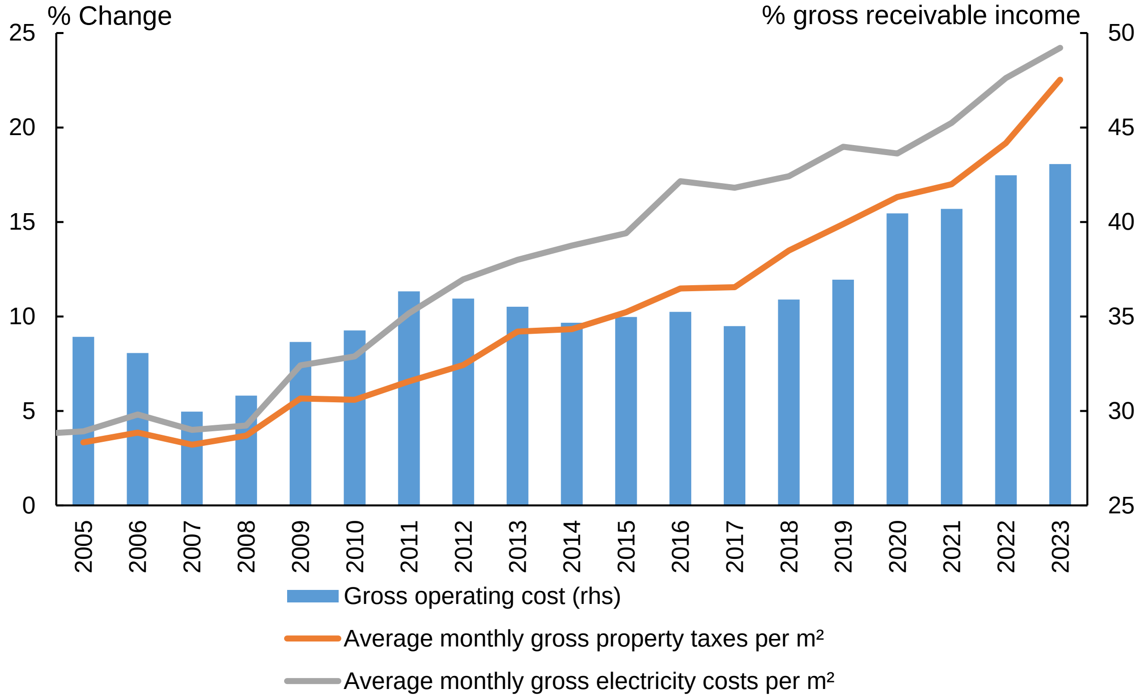
Source: MSCI/Rode and associates

4.2.1 Return and capitalisation rates

The overall capital growth is negative with the office segment being the highest contributor having recorded a depreciating value of approximately 2% in 2023 (Figure 8A). The negative capital growth in the office sector can be ascribed to the scarring effect of the pandemic. A decline in capital growth can lead to reduced collateral values, with broader implications for the economy. The uptick in capitalisation rates across various CRE segments suggests this heightened risk within the sector (Figure 8B). This traditional valuation metric, defined as the ratio of net operating income (NOI) to commercial real estate prices, points to lower expected property prices as the sector continues to face significant economic and structural headwinds. The increased capitalisation rates create uncertainty in the market, where buyers and sellers adopt a wait-and-see approach, leading to a standstill in the market and slowing down transaction activity. A decline in transaction activity can lead to reduced liquidity in the market, making it difficult for investors to buy or sell properties quickly.

Municipal and electricity costs are not only the largest contributors to overall operating expenses but have also recorded the fastest growth since the GFC (Figure 9). More concerning for the sector is that these costs continue to grow above consumer price inflation (CPI), negatively impacting real returns. Average monthly electricity costs per square meter as a share of gross receivable income increased from 16.8% in 2017 to 24.2% in 2023. Average monthly property taxes as a share of gross receivable income rose from 11.5% to 22.5% over the same period. Over time, this trend has contributed to weak investor confidence due to its negative effect on overall operating costs and property values.

Figure 9: Operating expenses

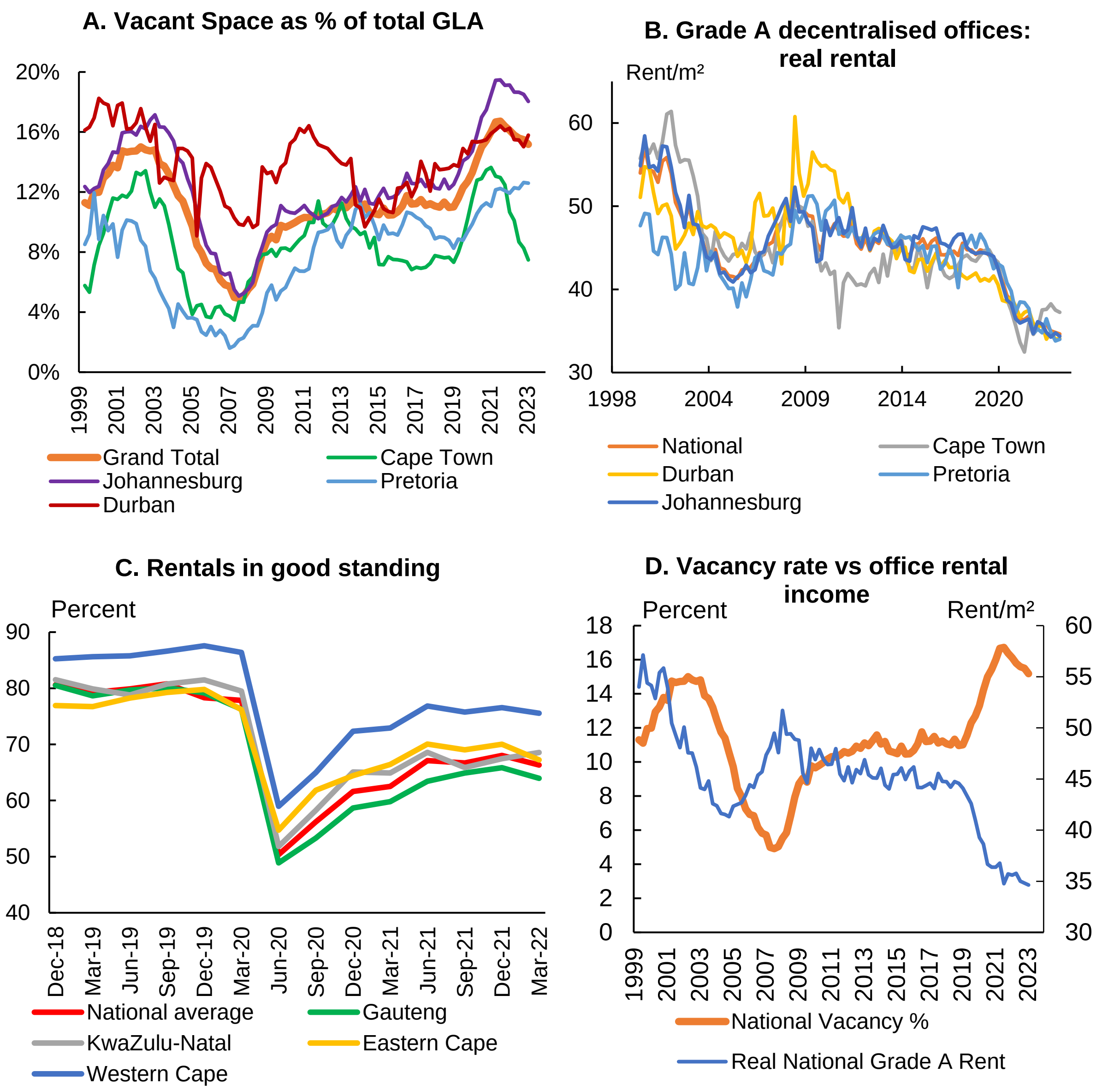


Source: MSCI

4.2.2 Vacancy rates and CRE income

The impact of COVID-19 and challenges relating to electricity supply by Eskom obscured the outlook for CRE. The shift away from traditional brick-and-mortar retail in favour of e-commerce and the WFH (to now hybrid) regimes adopted dampened demand for office and retail space resulting in higher vacancy rates. Semigration to Cape Town, resulted in better recovery in vacancy rates (Figure 10A) and real rentals (Figure 10B and C) for Grade A offices in Cape Town. The national vacancy rate is still well above the pre-COVID level and the long-term average, albeit recent signs of recovery, weighing negatively on rental income (Figure 10D).

Figure 10: Vacancy rates and rentals

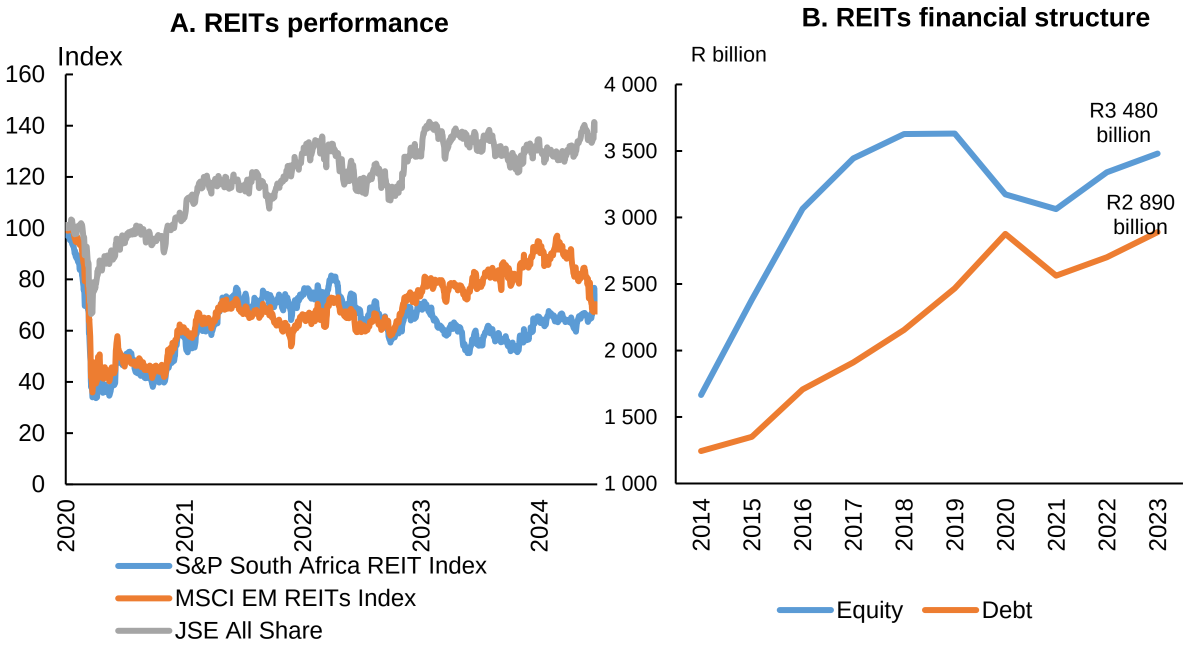


Note: Decentralised means all nodes in a metro lumped together, excluding the (old) CBD while GLA denotes gross lettable area

Source: Rode and associates

The contraction in rental income directly impacts property valuations and the ability of owners to cover operational, maintenance and debt service costs. The tenant payment behaviour further compounds these vulnerabilities. The variability in tenant payment patterns is influenced by factors such as property rates and taxes, which vary across different geographical areas. While some recent recovery is noted, the tenants in good standing[12] remain well below the pre-COVID level (Figure 10C). Defaults by tenants can reduce rental income further for borrowers, increasing the likelihood of debt defaults.

Figure 11: Performance of REITs



Source: Bloomberg

4.2.3 REITs performance

South Africa's REITs market continues to perform poorly compared to the MSCI Emerging Markets REITs Index and the JSE All Share Index (Figure 11A). The negative returns of SA REITs[13] since 2020 underscore the severity of the pandemic on the sector. This performance also underscores the spillover effects of structurally and persistently weak economic growth and the increasingly difficult operating environment given the tighter financial conditions, coupled with faster increases than CPI escalations in both municipal and electricity costs. The poor performance of the equity returns has in part resulted in the tilt towards higher debt financing in REITs capital structure (Figure 11B). The growing inefficiencies in local governments has affected the quality of service delivery, imposing indirect costs on property owners,

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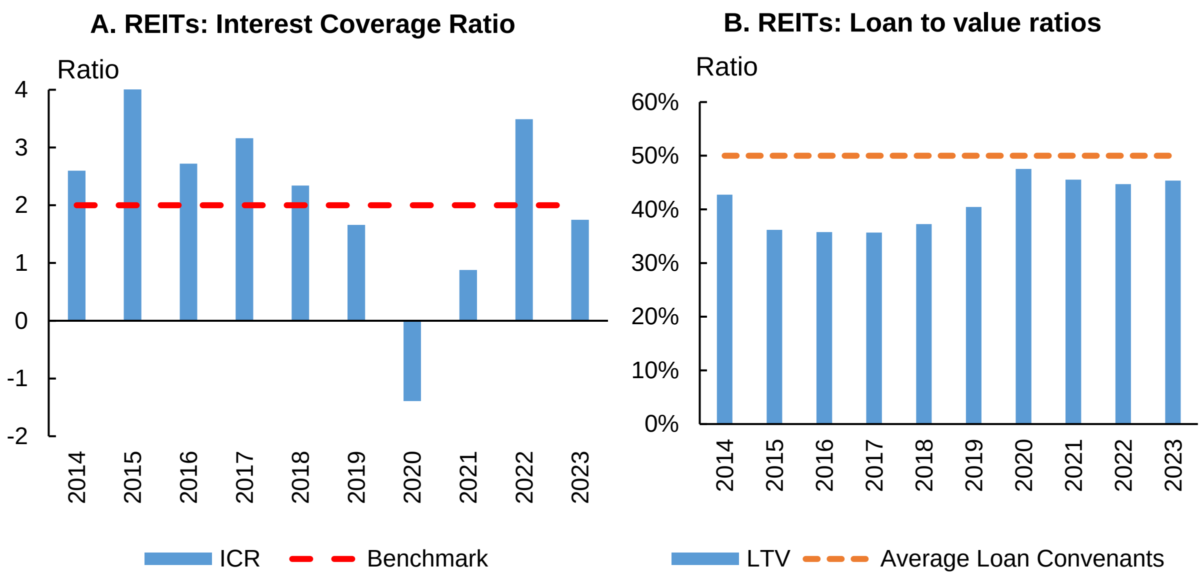
[12] The are tenants who consistently meet their lease obligations on time and in full.

[13] A Real Estate Investment Trust (REIT) is a company that derives income from the ownership, trading, and development of income-producing real estate assets. In South Africa, a REIT receives special tax considerations and offers investors exposure to real estate through shares listed on the Johannesburg Stock Exchange (JSE) (https://sareit.co.za/what-is-a-reit/).

including REITs.[14] The negative spillovers of this local government dysfunction are transmitted through steeper other operating costs (such as higher investments in security and alternative energy costs). The water supply challenges in some metros are also increasingly weighing on the sector's returns.

Local REITs' share prices have slightly increased since October 2023, driven by growing market expectations of an impending policy easing by the Federal Reserve, higher buying activity and the outcome of the national elections. However, the concern that remains is that this recovery may not be fully supported by sectoral market fundamentals, and as a result, it may be temporary and unsustainable in the long term.

Figure 12: REITs leverage ratios



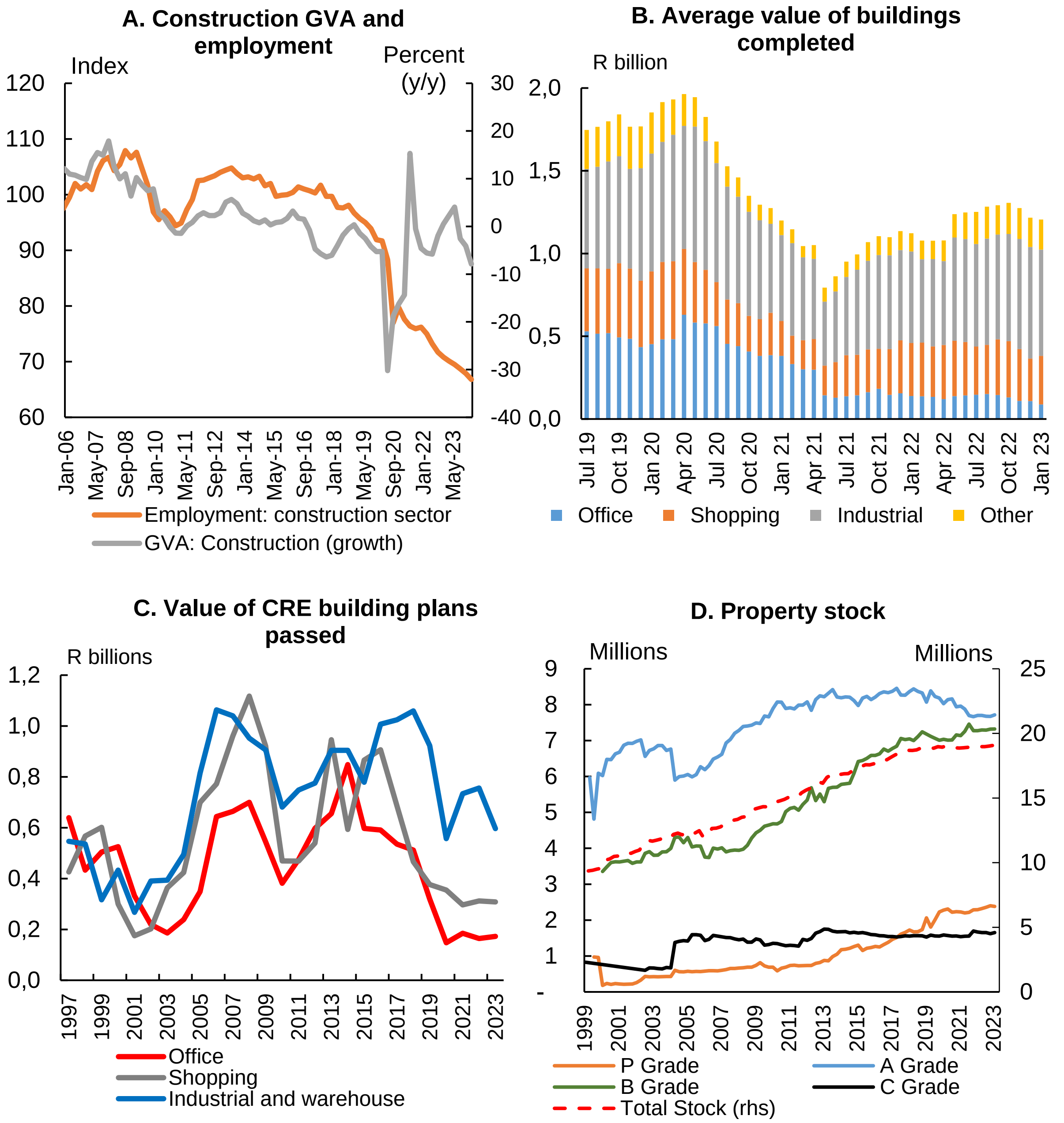
Source: Iress

The debt levels of REITs grew from R124 billion in 2014 to R290 billion in 2023, significantly increasing their debt service costs. The deterioration in the interest coverage ratio (ICR) since 2019 (except for 2022) to below the average ICR bank IMF benchmark of 2 suggests growing debt sustainability concerns in the sector (Figure 12A). This, combined with potential fire sales, could pose severe financial stability concerns for equity and debt markets. Although the loan-to-value (LTV) ratios are below 50%, ratios exceeding 40% raise concerns for investors, as they indicate a

14 See: https://stanlib.com/2024/04/11/sa-real-estate-investment-trusts-can-unlock-further-upside-by-emulating-their-global-peers/.

heightened risk of a refinancing gap. Additional borrowing and a decline in asset values could tip LTV ratios over this threshold. The increase in LTV ratios (Figure 12B) is largely through the valuation channel given the higher interest rate environment and lower profitability.

Figure 13: Construction activity



Sources: Rode and associates, TPN, StatsSA and SARB

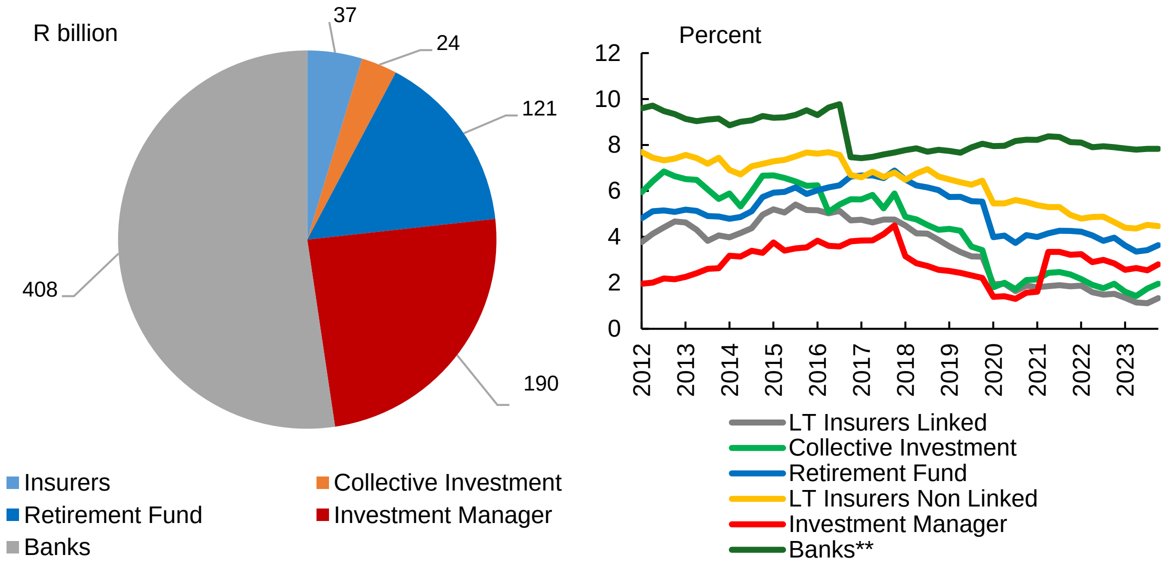
4.2.4 Construction activity

The CRE sector is vital for the real economy and employment channels (Figure 13A). Economic activity as proxied by gross value added (GVA) in the construction sector is trending lower, triggering job losses in the construction sector with negative spillovers to households and the macroeconomy through the multiplier effect. Leading indicators such as the value of building plans approved (Figure 13B) indicate that the sector is in a prolonged downturn, especially in the office segment. The average value of completed buildings shows that the office sector was the hardest hit by the COVID-19 pandemic while the industrial sector was the least affected (Figure 13C). Overall, the total property stock is moderating given the lacklustre performance in construction-related activity (Figure 13D).

Figure 14: Real estate exposure among domestic investors

A. Domestic property assets by investor type in 2023

B. Domestic property assets by investor type



Notes: In Panel A and B, NBFIs denote total domestic property assets as a proportion of total assets under management.

** In Panel B, Bank exposures are calculated as total CRE loans divided by total loans.

Source: SARB and PA

South African Reserve Bank

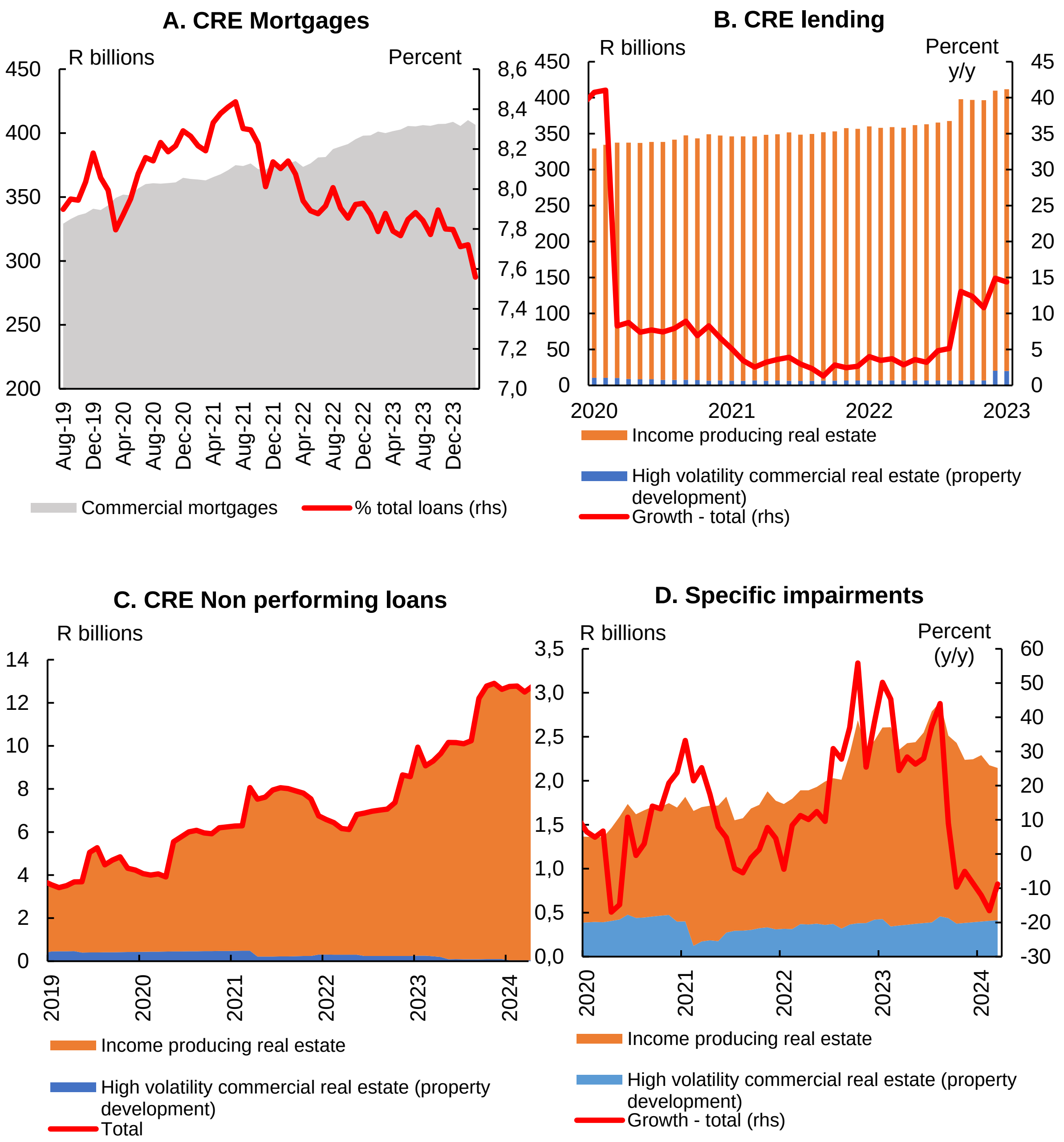
5. Interconnectedness between CRE and the financial sector

The considerable size of the CRE sector combined with its reliance on debt financing underscores its importance to the financial sector and the broader economy. Despite the decline in the growth of gross credit extended to the CRE sector over the years, banks still hold the largest share of exposures to CRE (Figure 14A). NBFIs provide an alternative source of funding for domestic borrowers as shown by the exposures in Figure 14B. Market intelligence suggests that the general decline in NBFIs may be an indicator of falling asset values or negative capital growth.

5.1 Banks

The slowing growth in credit extension to the CRE sector could suggest potential challenges in securing financing for new building projects or growing refinancing risks. Commercial mortgages, as a share of total lending, continued on a downward trend in the post-pandemic period (Figure 15A). The bulk of the CRE specialised lending was directed toward income-producing real estate, whose primary income for repaying the loan comes from the underlying property or business, increasing the risk of default in a downturn (Figure 15B). The credit quality of CRE assets continues to deteriorate (Figure 15C), albeit moderating in recent months as evidenced by a deceleration in specific (Figure 15D), largely due to the COVID-19-induced structural changes in the sector, coupled with persistently weak economic growth. Comparatively, exposure to CRE by South African banks is more modest than in larger economies like the US, where headwinds to the sector pose a greater risk to small and medium banks in particular.

Figure 15: Banking sector exposure to the CRE sector[15]



Source: PA

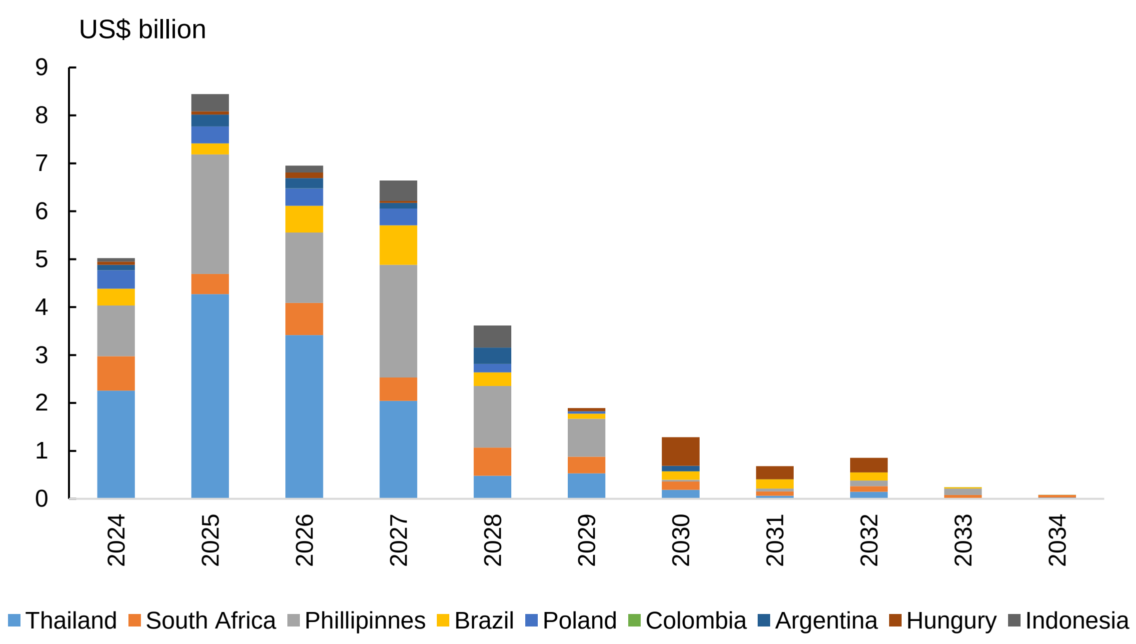
15 Income-producing real estate (IPRE) lending refers to a method of providing funding to real estate (such as, office buildings to let, retail space, multifamily residential buildings, industrial or warehouse space, or hotels) where the prospects for repayment and recovery on the exposure depend primarily on the cash flows generated by the asset (BIS, 2001). High volatility commercial real estate (HVCRE) lending is the financing of commercial real estate that exhibits higher loss rate volatility (i.e. higher asset correlation) compared to other types of specialised lending.

5.2 NBFIs

CRE debt and equity investments held by NBFIs (such as insurers, retirement funds and investment funds) could impact financial stability in the event of a negative shock. Similar to other jurisdictions, the NBFI channel can amplify the bank solvency channel given its high degree of interconnectedness with the financial system. Key vulnerabilities for the NBFI channel are underscored by the size of the assets as proxied by the growth of assets under management for real estate funds and the maturity risk of debt.

Maturity risk is quite significant across emerging market countries (Figure 16), given the wall of maturities between 2024 and 2027. In the post-pandemic period and more recently, during the higher for longer interest rate environment, rollover and refinancing risks are a concern given the challenges the CRE sector faces globally. In such a scenario, fewer lenders are willing to extend new loans, and existing mortgage lenders will be forced to either extend maturity or declare the loans in default. This maturity wall could create stress, potentially spilling over into the broader financial system.

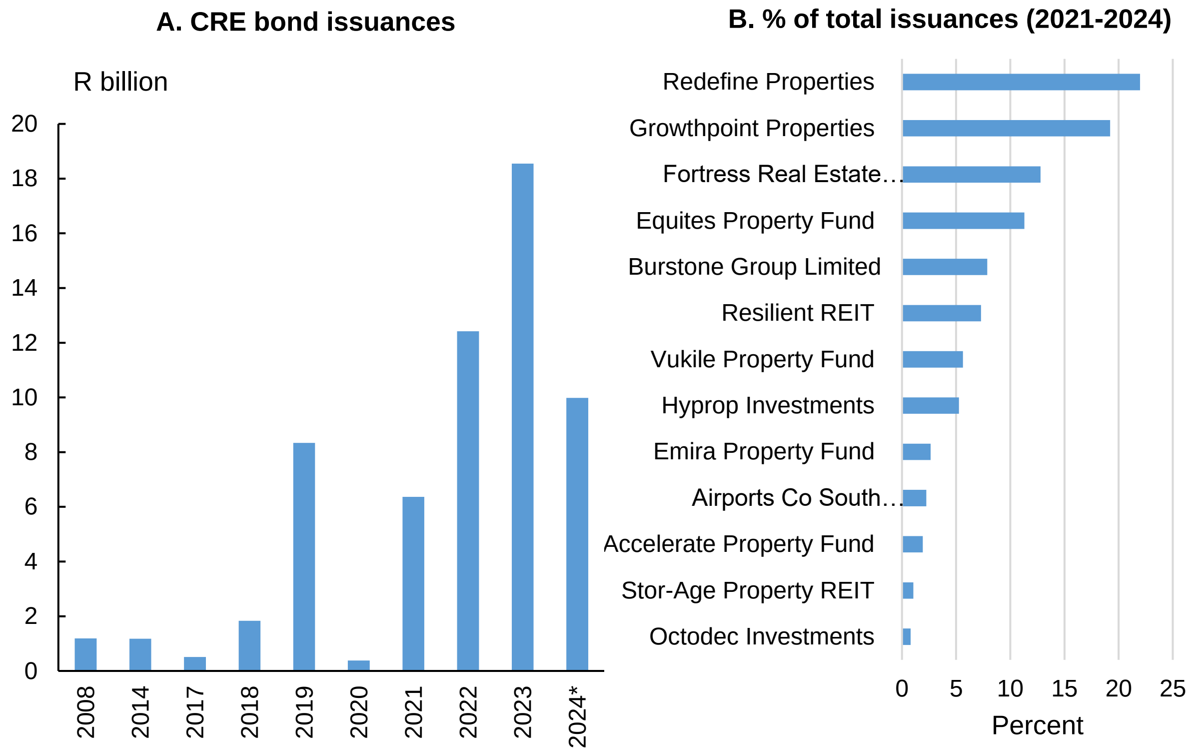
Figure 16 Maturity profile in selected EMs



Source: Bloomberg

Market access improved significantly for the domestic CRE bond issuers post the initial COVID-19 shock, in 2020. The issuances in 2024, on a year-to-date basis are at 54% of the 2023 issuances. Given some headwinds to the sector's outlook such as the impact of high interest rates, load-shedding and consumer strain, bond issuance in the sector may not surpass the 2023 level (Figure 17A). Such a scenario, interacting with the amount coming due in the near term, may result in the build-up of vulnerabilities associated with debt roll-over risks.

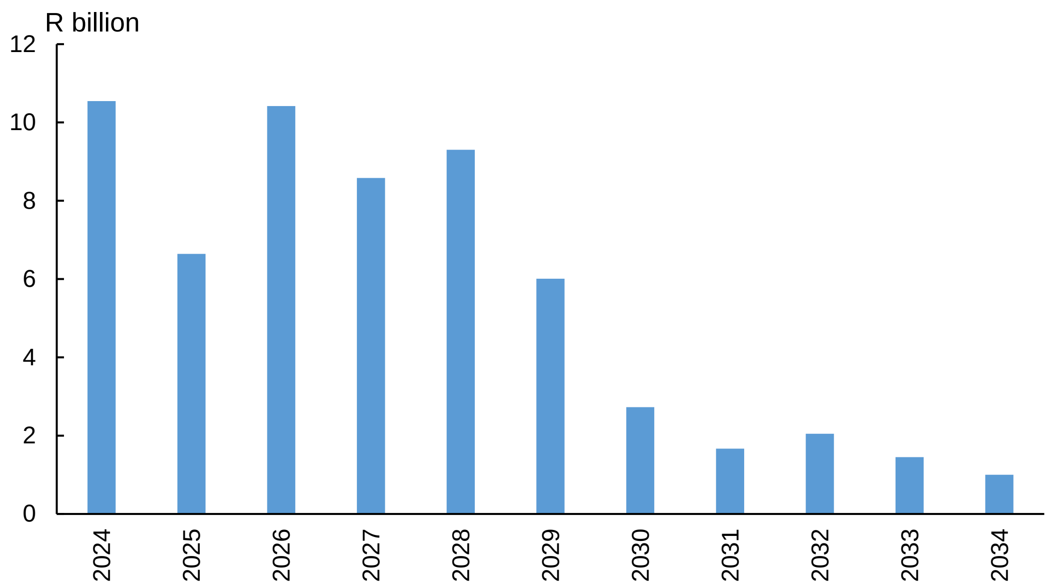
Figure 17: Debt issuance in the CRE sector



Source: Bloomberg

Concentration risk is apparent in CRE bond sector given the dominance of mainly Redefine Properties, Growthpoint Properties and Fortress Real Estate Investments. These companies constituted about 54% of the total sector issuances between 2021 and 2024 (Figure 17B). The bulk of the maturities for the CRE sector fall due in the short to medium term (Figure 18), increasing the roll-over risks. In a scenario where the current tough macroeconomic conditions prevail for longer, limited market access coupled with fewer lenders rolling over maturing loans, credit risk could soar as more defaults become likely. An examination of previous issuances vis-à-vis the maturating debt suggests that such market stress could be confined to the small issuers.

Figure 18: CRE bond maturity profile

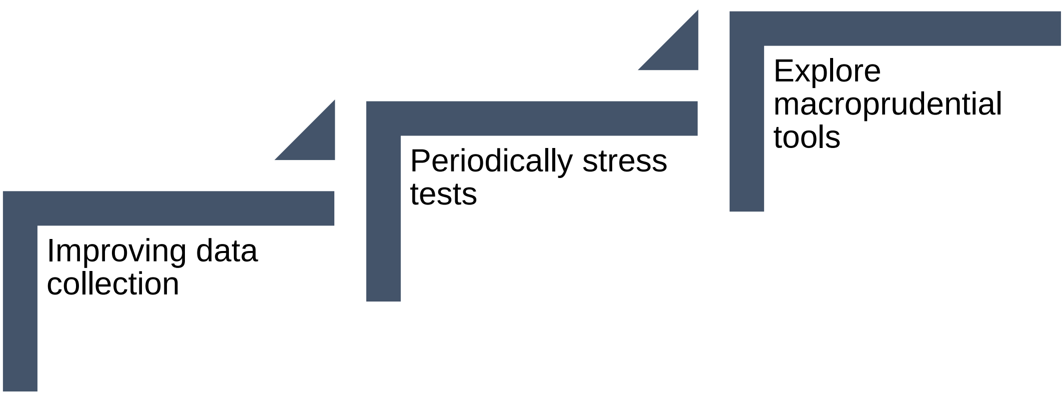


Source: Bloomberg

6. Policy recommendations

To enhance the resilience of financial institutions with significant CRE exposures, the following recommendations should be considered (Figure 19):

Figure 19: Policy options



Source: Authors' formulation

- **Improving data collection in the sector and the development of a Commercial Property Price Index** to ensure effective monitoring of risks and vulnerabilities.
- **Stress testing** exercises could periodically incorporate scenarios that include the potential impact of extreme weather events on the CRE sector. The stress test results of both financial and non-financial institutions can thus better assess the robustness of their capital reserves and adjust them accordingly to mitigate systemic risks.
- **Explore possible macroprudential tools, including those that could be applied to NBFIs.** Macroprudential tools are currently focused on the banking sector, but considering the high exposure of NBFIs, work should be done on potential tools to address systemic risks from this sector, should they arise. This will enhance the ability to mitigate systemic risks across the entire financial system.

7. Conclusion

Global and domestic conditions in the CRE markets are currently in a downward phase and this poses several financial stability concerns. Structural growth constraints, coupled with higher interest rates, have skewed the supply and demand dynamics in the CRE sector, negatively impacting cashflows and property values. In response to these pressures and potential future stress, investment and lending activities are deteriorating. Since the COVID-19 pandemic, financial imbalances in the domestic CRE sector have grown, though they are differentiated across segments, with the office segment being the worst affected. Intensifying incidences of extreme weather have further exacerbated all channels of transmission for CRE vulnerabilities. Domestically, both financial and non-financial institutions face potential credit losses from their exposure to the CRE sector. While investors could face large losses, systemic risks appear to be limited. A major limitation of this study was data constraints, although some initiatives to address these gaps have been identified.

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