ment grade credits if we subtract the cost of hedging?" she said.

Statistics over the last couple of years show price correlation across all worldwide asset classes has grown sharply, she said, posing the rhetorical questions: "Do we still think we have diversification while we actually have not? What about long-term stable returns if correlation tends to move up?" APG is in a process of re-thinking this thorny challenge. "If correlations continue to move up there is no way, with the current design and thinking, that we can come up with a well diversified overall portfolio… And we cannot call it a Black Swan because we know it. It's just not so easy to figure out what to do about it!" ■ **pie**

GUEST COLUMN

Regulation to impact bank property lending strongly

By Jens Tolckmitt, CEO, Association of German Pfandbrief Banks, Berlin

Many regulatory projects under way in the financial sector - Basel III, new supervisory rules for banks; bail-in, the possible involvement of bond holders in restructuring credit institutions; the Solvency II regime for insurers - have indirect implications for property lending. Although every single one has its own justification, it appears questionable if the cumulative effect has been considered. Basel III will require banks to hold considerably more and better-quality capital. That would have been a challenge even if banks had had several years to build it but the European Banking Authority has shortened the timeframe and it is not possible for all banks to procure adequate capital on the market simultaneously. The consequence is that risk assets have to be reduced and new lending scaled back. Combined with equity investors' expectations of an adequate return on capital, this will (have to) be reflected in credit conditions.

Some Basel III rules have direct implications for property lending. One is the leverage ratio which could require banks to hold the same equity capital against each loan regardless of risk profile. It is not yet clear if compliance will be mandatory but because property lending is a long-term business, banks need to prepare for foreseeable regulatory changes in good time. Thus, the leverage ratio is already dampening lending. It will lead to higher margins above all in low-risk areas of property lending, given the substantial regulatory costs. In the medium term, development of a sustainable long-term funding strategy is a decisive strategic challenge facing the banking industry. Regulatory measures are likely to make virtually all conventional bank funding more expensive; a funding mix needs to be found to ensure banks remain competitive.

Pfandbrief banks, in this context, have one crucial competitive advantage: the Pfandbrief itself. Even during the most turbulent weeks of the crisis, mortgage Pfandbriefe always found buyers. However, only the safest part of a mortgage loan can be funded, i.e. 60% of a conservatively-calculated mortgage lending value. Banks must rely on other funding sources for most of the rest – usually deposits or unsecured bank bonds, and policymakers seem to have an interest in banks making greater use of deposits. However it remains to be seen what effects deposit protection reform in Europe will have on cost and availability of this funding method. The market has already been largely divided up. Competition for deposits will thus be fought even more fiercely through price, and deposits will become even more transient - especially if a significant number of new competitors enter this market.

Funding via senior unsecured bonds is also likely to become markedly more expensive for banks and spreads have already widened since the financial crisis broke out. It is probable that they will remain at elevated levels indefinitely. A number of regulatory initiatives have the potential to raise prices and have, moreover, implications for each other. These are:

• The implementation of Basel III at the European level stipulates that capital backing for unsecured bank bonds purchased from other banks must in future be based, under the standardised approach, on the rating of the selling bank. This will make it much more unattractive for banks to invest in senior unsecured bonds, and investors will demand higher yields on investments of this kind to make up for the rising capital costs.

• The procurement by banks of long-term funding on the capital market relies primarily on investments by insurance companies and other institutions. That is why Solvency II will also have an indirect impact on property finance: it will make insurers' investments in senior unsecured bonds much less attractive than other asset classes – indeed less attractive the longer-dated these bonds are and the lower their rating. If insurers largely cease investing in one of the most important bank funding sources, this will have a palpable effect on the cost and availability of liquidity, and indirectly also on bank credit conditions.

• The situation is aggravated further by the planned participation of senior unsecured bond holders in bank restructuring costs; a draft directive was recently published which provides for a bail-in of bond creditors. Investors will agree to this additional risk only if it is reflected in higher risk premia. Moreover, because rating agencies have already announced that such rules are likely to negatively impact their ratings, this would likewise have a detrimental effect on the treatment of such investments under Basel III and Solvency II. ■ **jt**

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