

Risk management in real estate

What keeps real estate managers up at night?

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I read this in the paper the other day: *'Good Property Management should be supported by an efficient, Readily available Income base complemented by a Strong Knowledge Management Process'*. I think for a bit and I try it again, trying to read between the lines this time: *'Good Property Management should be supported by an efficient Risk Management Process'*. That's more like it.



Since the 1970s, TV series have been 'planting' hidden commercial messages in their scripts to capture the customer. Back then, regulation was light so statements like 'do you want a Coke or a Pepsi?' could easily slip into a script. Nowadays, the average consumer is smarter and may be too sophisticated to be interested in such a plain message process. Media businesses have found other ways to be successful in communicating such 'read between the lines' messages.

One way would be by introducing amazing new technology which is later made commercially available by one of their sponsors, using a sequence of images or words which directs the mind into thinking 'oh, I want some chocolate now', or 'I always wanted to go to Hawaii', etc.

Of course the question is: 'how all this is related to risk management in real estate?' Undoubtedly, the real estate industry has been one of the key drivers in the globalisation of capital over the past fifty years. The recent global recession, prompted by over-leveraging in many sectors including real estate, has resulted in increased focus on risk and stress across the real estate industry, and risk is now at the top of the agenda for owners, developers, managers, investors and, of course, regulators.

Stricter regulatory requirements, environmental and macro-economic exposure management, catastrophic modelling, data analytics and complex investor requirements (often involving financial institutions) are just some of the new era challenges facing the real estate industry. It is hard to escape the conclusion that the real estate investment landscape is undergoing rapid change.

Last year, we interviewed more than twenty stand-alone and embedded real estate fund and portfolio managers to get their views on the above. We conducted a series of brainstorming meetings, open forums and workshops in our Deloitte Analytics Labs and the result was quite astonishing as we see below:



This 'cloud-based' representation is quite simple and, at the same time, complicated in its meaning. Critically, the size of the font relates to the frequency with which each term arose. Does this frequency mean that this area is important for our client's business growth, cost base and risk exposure?

Is it regulatory or market driven? Does it provide insights into management decisions or does it hinder them? These are all questions that we challenged our teams in answering internally and in cooperation with our clients. The simple and most important question, however, remains the same - 'what keeps real estate managers up at night?'

If we look at the underlying analysis behind the cloud, as well as property level concerns such as tenant quality, lease breaks and exits, managers are now worried about their data, their risks and exposures, technology, the regulator, management and investor reporting, visualisation and outsourcing.

If we had these conversations five years ago, most of the latter would not even be in their agenda. An additional element to this is drive for change. Not appetite, but drive for change. Let us try to see why.

Why are real estate managers under pressure to change?

- **Information 'big bang'**
Management, investor and risk-sensitive information is growing exponentially and has to be managed and reported
- **Regulation is coming in hordes**
New regulation, varying across geographies, makes the ability to manage regulatory compliance requirements a high priority
- **Hyper-extended enterprise**
Mobile employees, a complex and legacy system environment as well as a highly networked ecosystem make processes complex
- **Virtualisation**
SaaS, Cloud and Cognitive computing, as well as the layers of outsourcing within property

management and investment administration have led to many processes being outside the boundary and control of the organisation

- **Visualisation**
Wide variety of internal and external stakeholders (managers, auditors, regulators, etc.) which require different information, greater visibility and better data accuracy in the organisations' risk and compliance state
- Internal Audit, **ERM (Enterprise Risk Management)** and Information Security are not designed to give a real-time dynamic view of an organisations' control state and risks
- The need to holistically manage common processes of the **data silos** that are already there and use old technology to manage the complex, diverse landscape of IT & Business





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How does this impact the business? Why are managers happy they are still achieving their targets but so nervous about how they manage their business? How can they achieve their vision and strategy while, at the same time, ring-fence their operations against risks and modernise/transform their business with a robust, secure and efficient decision-making mechanism?

We have identified three areas in which real estate managers seem to be focusing their attention presently:

1. Investors

Investors are looking for increased understanding on risks and returns and want access to the right information, at the right time (which is inevitably earlier than before). They also want to be treated fairly, interact with a competitive manager and get quality information for their investments. Furthermore, the information needs to be available anywhere; on their monthly statement, on the web, their smart phone, their tablet/phablet and even on their wrist watch.

2. Risk management

Risk management has been an area of major focus for every real estate manager we talk to. The need for enterprise risk management of alternative investments, incorporation of risk analytics and better management of risk data which leads to optimisation of risk reporting, are only a few of the challenges Chief Risk Officers (CROs) are called upon to tackle in their daily business.

Technology plays a significant role in this as CROs need their risk teams to have access to better and more accurate risk information faster. If we also take into account that this information has to be retrieved from many sources across the business including old, legacy systems and manual information calculated on spreadsheets, then it is evident that providing their risk insight is now becoming a major challenge.

Liquidity and market risk will tend to have a greater effect on funds that are more growth-oriented, as the valuation of appreciated properties depends upon market data. Conversely, interest rate risk impacts the amount of distributable income that is paid by income-oriented funds. The challenge therefore becomes even more complicated to tackle.

3. Regulation

Regulation is a hot topic across every industry and sector. However, there have been a series of changes and introduction of new directives and rules which are reshaping the regulatory framework in the real estate industry: AIFMD and Solvency II (particularly for embedded managers) are only a couple of the new regulatory environments which incorporate a series of management and reporting requirements. These requirements affect nearly every part of the business from the front office, risk and compliance, finance and accounting, operations and even legal.

Regulators are asking for information to be reported in a more accurate and enhanced way, including more metrics, more information across the business and more detail. Again, technology is a key factor as reporting managers are struggling to get the information they need to report at the time they need it.

So, what can real estate portfolio managers do?

How can they tackle these challenges? We do not aim to answer all these questions in this paper, but we have been working closely with real estate managers in helping them rationalise their data structures, applying analytics insights across their business and developing an optimised reporting framework, both internally to the board and externally to clients and the regulator.

There is a need for change and real estate managers are willing to embark on this journey. This is a journey that they need to invest in and effectively support and project manage to the end.

The competition is increasing, the investor demand is growing and so are the opportunities.