Andrew G Haldane: The Commercial Property Forum twenty years on

Remarks by Mr Andrew G Haldane, Executive Director, Financial Stability, Bank of England, at the Bank of England, London, 18 December 2013.

*   *   *

I would like to thank Oliver Burrows, Iain de Weymarn, David Gregory, David Learmonth, Varun Paul, Rhys Phillips, Laura Piscitelli, Martin Taylor and Jack Worlidge for their help and comments.

Tonight marks an important birthday. We are here to celebrate the 20th anniversary of the Bank's Commercial Property Forum. I am delighted to welcome members, past and present, back to the Bank.

The Forum met for the first time on 28th July 1993. It was hosted by my predecessor Pen Kent. Its aim, to use Pen's words at the time, was "to bring all sides of industry together" – developers, investors, lenders, occupiers, surveyors, auctioneers, researchers and regulators – to discuss developments in the commercial property sector.

Since then, the Forum has met around 80 times. It has done so under three external chairmen – Clive Lewis, Chris Bartram and Ian Marcus – and I am particularly grateful to them for their efforts over the past 20 years. The Forum has drawn on around 300 experts from across various sectors. By my reckoning, they have drunk over 1500 cups of tea or coffee and eaten over 2000 biscuits. I cannot think of a Bank committee whose caffeine and calorific intake could surpass the Forum's.

That twenty year period has been far from a quiet one, for the Bank or the commercial property industry. The Bank gained operational independence for monetary policy through the Monetary Policy Committee (MPC) in 1997; had its role in supervising individual firms first stripped from it in 1998 and then, earlier this year, re-instated through the Prudential Regulation Authority (PRA); and, most recently, has taken on responsibility for so-called macro-prudential regulation through the new Financial Policy Committee (FPC).

The commercial property industry's fortunes have been just as undulating. But throughout those ups and downs, the Forum has remained a key source of intelligence *for* the Bank and the industry and an important sign of cooperation *between* the Bank and the industry. Since 1997, the Forum has helped inform the deliberations of the MPC and, over the past few years, the PRA and FPC. And it was the success of the Forum that led me, three years ago, to set up a parallel Residential Property Forum, chaired by Nick Ritblat.

Some of you will have heard me say that the Forum is one of the best meetings I attend at the Bank. And I know some of you, on hearing that, have been left wondering just what my other meetings must be like. Speaking on behalf of the Bank, I wanted to say how grateful we are to you all for those contributions.

But what has the Forum achieved during its life? And, looking forward, what could it achieve in future?

Cycles of the past

Let me start with the bad news. The Forum has assuredly not solved the problem of boom and bust in the commercial property market. Indeed, the environment today – slow recovery from a jarring commercial property bust – is eerily reminiscent of the situation twenty years ago when the Forum began. As Yogi Berra reportedly said, it is a case of déjà vu all over again.

The Forum was born out of the commercial property crash of the early 1990s. Between 1989 and 1993, UK commercial property prices fell by 27%. This followed a long period of rising prices, high liquidity, expansive lending and weakening credit standards. These ingredients combined to create a classic pro-cyclical spiral. Higher valuations supported ever-larger loans on ever-finer terms, boosting valuations still further. When that pro-cyclical spiral went into reverse, it left banks, developers and investors all licking their wounds.

Today, the situation is much the same. Commercial property prices are 37% below their peak. For secondary properties, they are more like 50% below their peak. This fall-to-earth came after a long wave of rising commercial property prices, deeper liquidity and rapid and, in many cases, imprudent lending practices. The subsequent crash has left banks, developers and investors not just licking their wounds but in some cases requiring life support. The commercial property bust has contributed to several UK banks departing the high street and the economy suffering its most painful contraction since at least the 1930s.

This pro-cyclical, boom-bust pattern is, of course, neither new nor UK-specific. Over the past century, the UK commercial property market has experienced five distinct boom-bust cycles (Chart 1): in the 1930s, the 1950s, the 1970s, the 1990s and then again in this century. Peak-to-trough, the average price decline was 26%. The commercial property cycle appears to be every bit as regular as the business cycle, but with one key difference: its amplitude is perhaps three times greater.

That pattern is replicated internationally. During this crisis, commercial property prices fell by 22% in Japan, 29% in Spain, 34% in the US and 67% in Ireland. Earlier, commercial property lay at the heart of the UK secondary banking crisis of the 1970s, the US Savings and Loans crisis of the 1980s, the Japanese and Scandinavian financial meltdowns of the early 1990s and the Asian banking crises of the late 1990s. During those crises, commercial property prices fell, on average, by around 40% and often by much more.

The costs to the wider economy of these boom-bust cycles have been even more striking. Recessions that are accompanied by a property bust come with a much higher price tag. The cumulative loss of output from a residential property-related recession, for example, is around three times greater than a plain-vanilla recession at around 10% of initial GDP. Its duration is also around a third longer.

It may not be an over-statement to say that, historically, commercial property has probably been the most pro-cyclical sector on the planet. It has probably contributed more to financial crises, and associated output and job losses, than any other area of industry, outside of banking. This is all sobering context.

Cycles of the future

That naturally begs the question of what can be done to avert a next time? And what role, if any, the Forum might play? I think there are some positive developments to report. These hold out the prospect – no more than that – that next time *could* be different. But to be successful, these measures will need both industry and regulators to act decisively and in concert.

Let's start with industry. It is clear to me from the Forum's deliberations that the industry itself understands the need for change. That was brought home when a group of Forum members came together earlier this year, under the chairmanship of Nick Scarles, to produce "A Vision for Real Estate Finance in the UK". This was published in October. The recommendations in this report make eminent sense. For example, they include proposals to improve loan-level commercial real estate data. This would improve monitoring of aggregate exposures to the sector and modelling of real estate risk.

The recommendation that caught my eye related to valuation. Valuation lies at the heart of the pro-cyclical spirals we have seen historically in the commercial property market. Peaky valuations can give the appearance of a safety margin for lenders, causing them to loosen their grip on credit conditions, thus driving valuations higher still. Chart 2 illustrates this spiral in the UK. Valuations lead lending by around a year, with a correlation coefficient of around 0.75.

One way of slowing that pro-cyclical spiral would be to base lending decisions not on spot, but on medium-term or sustainable valuations. Any ramping-up of property prices above their sustainable value would not then automatically give the appearance of safety and thereby encourage looser credit conditions. That, in a nutshell, is the aim of the recommendation in the "Vision" document.

Needless to say, there is further work to be done by the industry to make these proposals operational. The very first minutes of the Forum highlighted property statistics and valuations as two areas where greatest improvement was needed. Twenty years on, that remains the case today. A continued effort will be needed by the industry to complete the job.

Next, regulators. For much of the period prior to the financial crisis, credit and asset price cycles were only of interest to policymakers to the extent they posed a direct risk to inflation targets or to the solvency of individual firms. Were a bubble to blow, then the most likely response was a combination of benign neglect on the upswing and lower interest rates in the downswing. The role of policy was to "mop" after the flood.

That orthodoxy has been sunk by the crisis. After perhaps the largest credit boom in human history, central banks globally are still frantically mopping with unprecedented degrees of monetary stimulus. Yet even that was insufficient to save the world economy from the "Great Recession". And the recovery from recession has been both slower and lower than almost anyone expected. Neglect of the credit cycle has shown itself to be anything but benign.

The lesson from all of this is very clear. As policymakers we must do a much better job of taking prompt corrective action to lean against financial swings which, if allowed to persist, would otherwise put at risk the financial system and wider economy. We need to build defences to protect against the collateral damage from financial flood. We need to be popping, not mopping.

Fortunately, that is exactly what is now happening. Regulators globally are pursuing a wholly new approach. It goes by the name of macro-prudential policy. And here in the UK, it is the responsibility of the Bank's new Financial Policy Committee (FPC).

Among the FPC's tasks is to lean against pro-cyclicality in the financial system. That means smoothing out the stomach-churning highs and lows in the credit and asset price cycle, which have characterised the past. As evidence of this approach, consider the FPC's recent actions in the UK residential property market. This market has defrosted at pace over the past twelve months. The financial stability risks from this re-heating may not be immediate, but nor are they hypothetical. Take the position of UK households.

Despite some post-crisis deleveraging households' debt burden, relative to income, remains high at around 140% – almost three times its level in 1980. As long as house prices rise faster than wages, as they have during the course of this year, this upward creep in households' debt burden will continue. And the higher this debt burden, the more sensitive will household spending be to any eventual upwards adjustment in mortgage rates.

In some ways more important from a financial stability perspective is the distribution of mortgage debt. Households representing almost 20% of this debt have a debt-to-income multiple above 5 – that is, around 1 million households. Around a third of debt, or around 1.6 million households, is owed by those with a debt-to-income multiple above 4. Just over a quarter of this debt is owed by households with £300 or less in monthly disposable income after essential expenditure is taken into account. And just over a half of all UK households say they would need to take corrective action (cutting spending, working longer hours etc) if mortgage rates were to rise by as little as 2.5 percentage points, if income were unchanged.

None of this is to suggest an immediate problem, especially with interest rates so low. But financial stability is about protecting against future tail risks. It was against this backdrop that the authorities recently decided to reduce some of the stimulus being provided to mortgage lending – for example, stimulus provided by regulatory capital relief and the Bank's Funding for Lending Scheme. As importantly, however, the FPC also set out its stall on what other macro-prudential measures could be taken to slow the accumulation of credit and debt, if these at some point put the financial system or economy at risk.

While this combination of measures may have appeared modest, they represent a big philosophical shift from the past and an important signal for the future. Regulators, certainly here in the UK, have clearly signposted they are no longer willing to turn a blind eye to pro-cyclical swings in property, or any other sector, which risk tripping up the economy. We can no more eliminate the credit cycle than we can the business cycle. But can we do better than watch on in horror, mop in hand? We can and we must.

The virtue of having this second set of instruments is well illustrated in the current environment. Macro-prudential measures can help guard against the financial stability risks otherwise associated with extra-ordinarily loose monetary policy. In the UK, the FPC can help support monetary policy in its task of driving forward recovery in the economy, by avoiding the MPC having to look over their shoulders for fast-approaching financial stability risks.

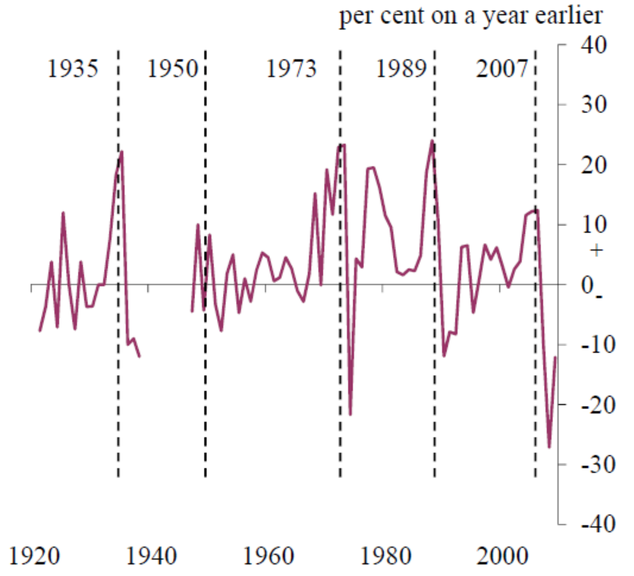
In situations like these, two arms – monetary and macro-prudential policy – are surely better than one in securing macro-economic and financial stability. And having both arms attached to a single body, as here in the UK, can in turn help achieve greater coordination between monetary and macro-prudential policies. There is a quiet revolution underway in the UK's macro-economic policy framework.

Conclusions

On its 20th birthday, it is clear that the Commercial Property Forum has never been more important. The boom-bust cycle in the sector is simply too damaging to be left to free-wheel. It is high time to develop some properly functioning gears and brakes. That is now being done, as a shared effort between the industry and the authorities – in Pen's words, "to bring all sides of the industry together". If this is successful, the Forum could not ask for a better birthday present.

Chart 1

Long-run UK commercial property capital values[a]

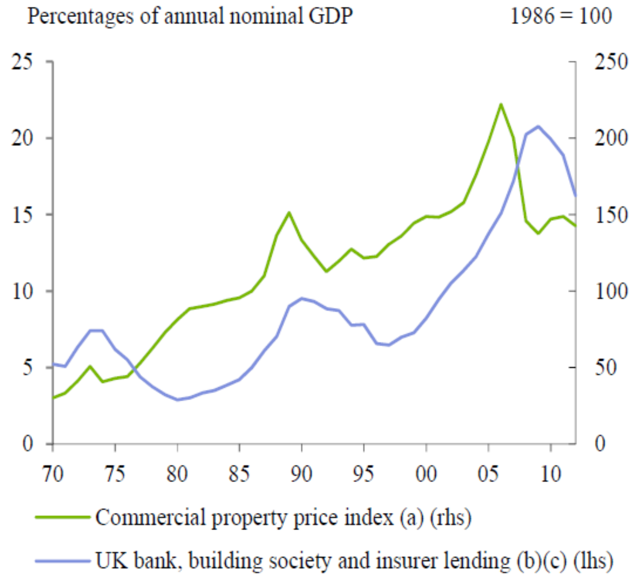


Sources: Scott (1996), Investment Property Database and Bank calculations.

[a] The vertical dotted lines indicate the discernable booms and busts. The attached labels indicate peak years.

Chart 2

UK commercial property debt and valuations



Sources: Association of British Insurers, Bank of England, Investment Property Databank, ONS and Bank calculations.

[a] Based on end-year data

[b] End-year stock of outstanding lending

[c] in 2010, 2011 and 2012 this includes an adjustment to include CRE loans transferred to the Irish National Asset Management Agency