Mr. Kent examines the challenges facing the UK commercial property market as it moves towards the 21st century Speech by Mr. Pen Kent, an Executive Director of the Bank of England, to The Investment Property Forum Annual Lunch in London on 15/1/97.

Introduction

1 The IPF has built up a significant and diverse membership in recent years and has deservedly become one of the most prominent and respected trade associations within your industry. I am delighted to have the opportunity to address you all this afternoon.

2 When Mark Burton suggested that I might look back at developments in the commercial property market during the eight years that I have been doing my present job, that appealed to me because I shall be retiring from the Bank next month. But I also like to look to the future and to identify coming issues and challenges. With that in mind, I will also pick out some of the factors relevant to the industry as it moves forward.

The Past

3 My involvement with commercial property began in 1985, when plans for Canary Wharf were beginning to materialise. One of the questions put to the Bank by the developers was whether we would change our policy encouraging banks to have their offices close to the Bank. We recognised that our policy was distorting the market and we decided to make the change. I have followed the property story ever since. But, for today's purposes, I shall take as my starting point a speech given by the previous Governor to the RICS in Paris in October 1989. You will recall that everything in the garden then seemed rosy. Cranes were everywhere on the horizon; there was an expectation that rents and capital values could only move upwards. Banks were developing innovative financing techniques and competing fiercely with one another to finance all this activity. Income returns were not out of the ordinary but the market was underpinned by the prospect of capital gain.

4 Yet some participants and commentators were beginning to have concerns about the scale of development. The Governor questioned whether there would be sufficient demand for the supply coming on stream. He noted too the banks' rapidly growing exposure to the sector. The sector was quite simply heading for overcapacity and overgearing. Why did the lenders not see it coming? Perhaps inability or unwillingness to see the big picture was one reason - but more of that later. We have been asked quite often why we as the supervisor of banks did not stop them overlending. The answer remains the same. The banks have to be responsible for their own commercial decisions. We are there to protect their depositors, not their shareholders. But we can usefully draw their attention to gathering clouds - and that is what we did.

5 As we all know, the required level of demand did not materialise. The resultant oversupply of space contributed to one of the most severe downturns that the commercial property industry has ever seen. Since then, other asset classes have outperformed commercial property in most years. Many institutional investors have responded by continuing to reduce their property holdings. Property companies have suffered; we have seen some high profile failures and reschedulings. The banks have suffered very sizeable losses on commercial property. Construction companies and associated professions such as architects and designers have suffered from the reduced workload on commercial property. And we must not forget the

valuing and surveying professions; the upturn in insolvency-related work was not sufficient to offset lower turnover and the corresponding heavy pressure on fees.

6 Possibly the only ones to benefit from the downturn were tenants fortunate enough to sign new leases in an environment of falling rents. The modest extent of subsequent development has probably meant that even these ‘beneficiaries’ have had a more limited choice of accommodation.

7 Other factors have also made the market very challenging, especially for investors and lenders. These have included the speed of building obsolescence and growing pressure on companies to manage property resources more effectively. Several initiatives aimed at enhancing the market’s efficiency and attractiveness made little headway in the first half of the 1990s. These included efforts to enhance liquidity, to develop property derivatives, and to improve information on the very sizeable part of the market that is not ‘prime’. In addition, efforts to enhance transparency have not progressed as well as I myself and many market participants had hoped.

8 There have of course been some positive developments, such as the development by BZW of Property Investment Certificates, the growing importance of data produced by the Investment Property Databank, and the development by RICS of new valuation standards in the revised Red Book. Some of the trade associations, such as the IPF and the Association of Property Bankers, have also developed well and have begun to play a very important role. I believe the Bank of England’s Property Forum, set up in 1993 to bring all sides of the industry together, has also made a positive contribution. But these developments cannot obscure the fact that, on the whole, this period has been one of disappointment. Property’s poor performance in the past few years has undoubtedly caused some to consider very carefully whether or not they wish to remain in property.

The Present

9 Are we turning a corner? The commercial property market is important to the UK economy in many ways. Property and related activities such as construction make a significant contribution to GDP. The availability of property of the right standards at the right price is very important to UK competitiveness. This puts some onus on landlords to provide what is wanted. It is equally important that the planning authorities should continue to provide a consistent and flexible planning framework in which developers and landlords can operate and earn a satisfactory return. It is pleasing that the market is at last beginning to show signs of strengthening. Indeed there is some evidence of incipient overheating.

10 Many institutional investors are taking the view that commercial property will be one of the better performing asset classes over the next couple of years and there is significant buying activity both from UK and overseas. There are increasing signs of development, involving both institutional investors and, on quite a large scale, property companies. And the banks too have been showing strong interest in the sector, with many new entrants joining the large number of more established participants.

11 Finally, there are encouraging signs of progress on several initiatives. The IPF has made its case to the Treasury for a change in the tax status of securitised vehicles, and others are looking to develop existing routes. Many investors are telling us that progress on securitisation will be crucial if they are to remain in property at all, so the better tone is not a valid excuse to give up on structural improvements to the market. There is welcome progress on

the derivatives front, through BZW's Property Index Forward instrument and the REIM initiative. Some participants are showing interest in improving the quality of market information. The Incorporated Society of Valuers and the RICS are funding research by IPD into the performance of the secondary market and, although this project is still in its infancy, I hope very much that you will support these efforts as the project develops. Indeed, on the basis that transparency generally improves the performance of markets, I would, personally, support John Ritblat's opinion that commercial transaction prices should be made public through the land register. Some of you would lose proprietorial advantage as a result in the short term, but in the long run a more liquid market benefits the most professional more than the free riders.

12 It would, however, be rash to conclude that the market is now unambiguously healthy in all respects. There are still several factors which will continue to pose challenges to the investment, banking and valuing communities. For example, while lease lengths may have temporarily stabilised, break clauses exercisable by tenants are becoming more common. And despite the positive tone of the recent CBI/Grimley survey, it is clear too that many occupiers will continue over the long-term to reduce their needs for space and to demand greater flexibility. Privity of contract has disappeared on new leases. All of these factors are making it less straightforward to form a view of the quality of cashflow likely to stem from a particular building.

13 There is a sizeable overhang of unlet secondary property. The pool of such property increases every time that a major user of space moves into new offices and releases its former premises. While some of the better quality secondary property can be refurbished at an economic price and relet, much of this stock may never again be relet for its present use and may not lend itself readily to conversion for alternative uses. This will continue to exert a dampening influence on the market, and imaginative solutions will be needed.

The Future

14 So, the market may be improving but it is still not easy. How is the market likely to develop over the next eight years? What will I be saying if you invite me back in the year 2005?

15 As we all know, the property market has, historically, moved in cycles. Some, notably RICS, have done work to develop our understanding of these cycles. The economic cycle itself is clearly one of the driving factors, though it is clear too that property is subject to its own fluctuations and its own step changes. Contributing factors include the strength of tenant demand, the activities of developers and the willingness of lenders to finance investment and development.

16 My story in the future could be similar - perhaps depressingly similar - to my review of the recent past. Many of the 'ingredients' that contributed to the last cycle are certainly present now. Institutional investors are attracted to the sector in the short-term but they could easily resume their longer-term departure from property in a couple of years. This could happen if property's performance runs out of steam as the economic cycle progresses and other asset classes begin to look more attractive. It is conceivable that the banks might become disillusioned with property again, particularly if they relax their lending criteria too far in the current exceptionally competitive lending market. This could also happen if they are seduced by the outlook for the better properties into taking excessive risks on the secondary and tertiary sectors, for which the outlook generally appears rather less bright. We are in favour of healthy competition among lenders but history suggests that the seeds of tomorrow's losses are sown

when lenders relax the basics such as loan to value ratios and income cover; or when they take very bullish views on the likely strength of cashflows. We hear that some lenders are seeking to pressurise valuers into higher valuations. This is not a healthy practise and we hope both the lenders and the valuing profession will be strong enough to resist and will stick to the principles of the new Red Book.

17 There are undoubtedly differences between 1989 and this stage of the present cycle, perhaps the most notable of which are the comparatively limited scale of speculative development and more realistic expectations. And notwithstanding my rather jaundiced remarks above about forgotten lessons, some of the risks involved in commercial property are now better understood. This could simply mean that this cycle will repeat history but in a less pronounced way than last time. Perhaps I should at this point recognise the VAT changes announced in the last budget. These have caused a strong reaction from the property industry. They have caused a halt to a number of major deals. I do not know how the matter will be resolved and will not speculate whether the impact will be lasting. More of that no doubt in coming weeks. But are there any other new influences which could bring about a different - and better - outcome than the last cycle? There are at least four other important factors which arguably did not exist in 1989. They may all make the market less volatile in the years ahead. Let me be a bit visionary.

18 The first of these is a low inflationary environment. The political constituency for low inflation is now almost certainly stronger than at any time in living memory. There is a real prospect that a low inflation environment can be sustained into the future. This is a profound change and should help to smooth the path of future economic cycles. This environment is likely to mean slower growth in nominal rents and also less volatile capital values. The emphasis will continue to change from capital gain to running yield. Poor investment or loan decisions will not be forgiven by inflation. This environment will alter attitudes to property, especially among users who will increasingly regard it purely as a factor of production subject to the full disciplines of cost controls. But lower nominal rents need not mean lower real income.

19 The second fundamental difference lies in the role, and potential, of the Private Finance Initiative. In many ways, the PFI simply reflects processes already underway in the private sector whereby occupiers are seeking more flexible arrangements and are prepared to pay a price for changing the traditional relationship between landlord and tenant. It opens up the possibilities for more imaginative use of property, and the principles are applicable both to public and private sector users of property. The providers of services, whether public sector or private, no longer want automatically to own the productive assets needed to provide them. They prefer to rent them instead with a higher level of service as part of the deal. Landlords with property expertise are well placed to provide this wider type of service and have a competitive advantage in doing so compared with less experienced operators. And maybe the word "property" will itself imply something too narrow. Owners will provide a working environment. They may move from "core and shell" to "finish and facilitate". Indeed in some PFI cases the owners will go even further and operate as well, "provide and process" you might say. This would give outsourcing a new meaning. Perhaps from your point of view it should be called <u>in</u>sourcing. If risks are properly identified and priced, the PFI potentially can provide the longer-term bond-type investments that many of you are seeking. It offers great opportunities to all of you. This revolution has only just begun.

20 A third issue that is particularly relevant now is technology. It has undoubtedly contributed to property obsolescence. But technology is potentially an important ally, and in more senses than one. Developments in building and construction techniques, as well as smaller and more powerful machinery and computer technology, facilitate the construction of buildings

that meet occupiers' needs. Information technology enhances the usability and efficiency of property as an asset class. Just as Mr. Otis made skyscrapers possible, one of you will create completely new configurations of site exploitation - or develop new and integrated relationships between different buildings. The automobile and advertising have entirely altered the shape, size, appearance and location of shops in the USA - and to a lesser extent here. But today's offices still look pretty much to me like those designed by Frank Lloyd Wright. Is there scope for an IT driven revolution in the next eight years in which the working environment is transformed into a virtual reality? I do not know but I am convinced we ain't seen nothing yet.

21 The fourth factor could make an important difference - greater market liquidity and instruments such as derivatives which will facilitate short-term tactical position-taking or investment. The enthusiasm and momentum for them is apparent both from what the market tells us and from recent surveys. A clear message from our wide range of property contacts is that greater liquidity is essential if commercial property is to remain attractive as an asset class. There is equally a clear message that successful development of securitisation and derivatives will not on its own be the saviour of commercial property. But without it property will not turn in a performance which can stand comparison with competing assets. We need a mature, liquid cash market in property with a healthy derivative market to permit successful management of risk. These are essential characteristics of efficient markets which are necessary for efficient use of property by users as a factor of production. Without such a development there is a risk that the costs of doing business in the UK will be uncompetitively high. I do not know how, or indeed whether, the obstacles to the development of such markets can be easily found. But I regard these issues as nationally important.

Conclusion

22 So, what is likely to happen in the next eight years? Let me sum up my vision.

23 The current strong commitment to keeping inflation in check will create conditions more conducive to rational long-term decisions. Commercial property is still to a large extent a longer-term asset and should benefit from this environment. The market will require property investors and owners to recognise and adapt to changing requirements from the users, particularly their increasing wish to manage the risks of property occupation more efficiently. It will require a willingness to work in partnership with tenants and to exploit the benefits of technology to the full. Lenders and other property professionals will need to understand and embrace these changes. I know that some of you already recognise this. Some of you are not afraid of the PFI. We have recently had the end of history, the end of politics. Will the end of distance be next? Will "location, location, location" be replaced by "communications, communications, communications"?

24 This environment offers opportunities which you may - or may not - wish to take. Those who take these opportunities will be the survivors and thrivers. I leave you with my old refrain ringing in your ears: transparency; liquidity; intelligent investment; revenue not capital gain; innovation - all the qualities of a deep, high quality market place.