The role of property in our economic life

In a speech to the British Property Federation,[1] *the* **Governor** *discusses the ways in which stable non-inflationary growth is likely to change the role of property in the UK economy. During the post-war period, residential property has come to be viewed as a form of saving with high returns, while commercial property has been valued largely for its investment qualities as a financial asset. But once low inflation is seen to be firmly established, the* **Governor** *argues that the role of property in all investment portfolios, whether of householders or of other forms of collective savings, will be evaluated on its own merits rather than as a store of value or as a means of speculative gains in inflationary times. He suggests that the benefits of a low inflation economy would include a revival of the rented residential sector, thus channeling more savings into productive investment, and notes the need to review particular aspects of long lease contracts, such as privity and 'upwards-only' rent review clauses. Looking to the future, the* **Governor** *does not expect a rapid recovery in the property market. But he urges that we must not allow inflation to be the route by which values are restored. One way of helping the recovery and of encouraging a more efficient market would be to improve the availability of consistent comprehensive data on the property markets.*

I last had the pleasure of addressing the Federation in May 1987. At that time I concerned myself with the changes wrought upon the City office market by the impact of Big Bang. I also discussed more generally the property market as a whole, given its historical vulnerability to peaks of supply and demand. I said then that, despite the rapid growth in bank lending to property companies, from £2 billion in 1979 to some £11 billion at that time, the Bank did not feel that the banking system as a whole was over-exposed to property. But it subsequently became so, with lending to property companies reaching £40 billion at the peak and even in 1987, I felt it necessary to warn that apparently attractive security could be rendered illiquid if a downturn in the market were to curb demand for certain types of property. For these reasons we believed it necessary to maintain a careful watch on developments.

That earlier theme drew on the lessons of previous experience with the property cycle. This time I should like to explore the notion that the role of property could undergo a sea change, as we pursue our goal of stable non-inflationary growth. Property will remain important as a factor of economic life, but I suggest that certain traditional assumptions about the market need to be re-evaluated as distortions, such as inflation, are removed. The objective is to permit investment and development decisions to be taken on the basis of a realistic assessment of the role of property in an economy that can be expected to grow in a stable and sustainable way. In developing this theme I will, I hope, be adequately addressing the title of your conference, namely 'Property in the 90s: Approach to Recovery'.

Residential property

Before I look at the problems in the market for industrial and commercial property, I should like to touch briefly on the residential sector. The pent-up demand of the Second World War and the years after it when building materials were scarce, created the conditions for a boom which was accentuated by tax incentives. Home-ownership was seen as a laudable social goal, especially as post-war purchasers saw the value of the investment in their property rise. The building societies which helped purchasers achieve this goal also helped savers by offering them good rates of return yet apparently minimal risk, since their money was ultimately secured against property whose nominal value scarcely ever fell. The effect of growing demand was to drive prices upwards more rapidly than inflation: this added the final twist. Property became seen not only as the best hedge against inflation, but even as a form of savings which offered high, sometimes very high, returns which dwarfed and ousted other savings opportunities. This forced prices up even more quickly, which in turn further stimulated demand as purchasers extended themselves financially in order to participate as much as possible in a game in which it then seemed no one could lose.

We know only too well now what trouble this game could bring, especially to purchasers who now find themselves owing more than their property is worth at a time when many families face hardship through reduced earnings and unemployment. In the long run it must be no bad thing that residential property prices should be more realistic—it will be much to the advantage of new first time buyers for instance. But that is no consolation to those caught when the

(1) Delivered by Pen Kent, in the absence of the Governor, on 20 January 1993.

market peaked, and we must all—lenders and government—remain sensitive to their particular difficulties.

The encouragement towards home purchase in the United Kingdom has been made greater in the post-war period by the bias against renting which was supported by legislation and the tax system. Steps have been taken to counter this. Moreover low deposit requirements and high earnings multiples for lending for house purchase have meant that savings have been channelled into bricks and mortar, rather than commercial enterprise. But it is no use casting envious eyes on other economies like Germany's with healthy rented sectors unless we establish the same conditions here which make this possible, and top of the list is low inflation. One of the benefits of the low inflation economy which is our goal would be a revival of the rented sector, with the bonus of improved mobility that it confers. Provided we succeed, the role of property will change. It will no longer have the allure of being the fastest route to personal and corporate wealth nor itself add in this way to more general inflationary pressures. As the Chancellor has also made clear, movements in house prices will certainly be amongst those asset prices taken into account in monetary policy discussions and they will be discussed in the Bank's new inflation reports, the first of which will be published next month.

Commercial property

Let me now turn to commercial property. In the past, commercial property has been evaluated largely on its investment qualities as a financial asset rather than on its value as a factor of production. These investment qualities have been driven by distortions in the market and by pronounced cyclical demand. As a result, I believe we have lost sight of the more fundamental productive role of commercial property in the economy. The most recent comprehensive attempt to quantify its importance was provided by a report by the London Business School, commissioned by the Royal Institution of Chartered Surveyors. This report estimated that, in 1989, the total value of UK commercial property was £250 billion. At that time, this was double the nominal value of the gilts market, and about one half of the value of the total UK equity market. The share of economic activity connected with property was estimated at between 6% and 10% of GDP, depending on the breadth of definitions used. Developments since 1989 may have adjusted some of these figures, but there can be no doubting the continuing importance of the commercial property sector to the UK economy. Almost every business therefore needs to pay careful attention to its use of property as part of the process of adding value and making profits.

The scale of the current slump in commercial property rental and capital values needs to be set in the context of earlier downturns. The historical record shows that the highly cyclical nature of the property market is a long established phenomenon, probably extending back to the pre-industrial era.

We all recall that, over the last two decades there have been three main booms in the commercial property market: during the early 1970s, at the end of the 1970s and at the end of the 1980s. The first and last of these episodes witnessed the most dramatic rises in property values over this period and in each case boom was followed by a severe slump in values, while the smaller property boom of the late 1970s was followed by a somewhat more muted decline in values in the downswing. This broad picture conceals differences between the various segments of the market. For example, industrial properties, which tend to be under-represented in property investment portfolios, declined in value during the early 1980s at least as severely as in either the mid-1970s or the current downturn, because the recession of the early 1980s particularly affected the manufacturing sector.

We all know only too well how the recession has affected property companies and the property assets of other enterprises. Comparisons have been widely drawn between this recession and that of the mid-1970s, but there are two important differences. First, investment and development have been funded in recent years much more by bank finance rather than institutional money. Second, in this recession, property rental values have declined in absolute as well as in real terms. In the mid-1970s high inflation meant that relative price adjustments could be achieved more easily without declines in nominal prices. Absolute declines in commercial property rents were largely avoided—although office rents did decline somewhat in the mid-1970s—and declines in nominal capital values were smaller than they would otherwise have been. With inflation lower in the 1990s, the adjustment to the oversupply of space has required significant declines in nominal rental values across all property sectors. This has meant that capital values have suffered a sustained fall in real and nominal terms, with severe consequences for property as collateral for corporate borrowings.

A recent study for the Royal Institution of Chartered Surveyors into the impact of commercial property values on corporate borrowing draws the perhaps unsurprising conclusion that there is a strong correlation between the two. As the sharp fall in property values has affected both existing banking covenants and capacity to borrow further, there is an implication for recovery prospects, monetary growth and economic activity. I am sure that the banks will continue to play their traditional role in providing funds for industry, but I think it probable that more detailed credit appraisal will tend to lessen the heavy reliance on collateral that has existed in the past. With this will go, I hope, a better long-term relationship between lender and borrower under terms which reflect all the risks involved.

Property as an investment

I should like to turn for a moment to the investment attractions of property. It is significant that the all-property yield ran at a fairly constant discount to the long-term gilt yield for many years but, since mid-1991, the all-property yield has been greater than the long-term gilt yield. This fundamental shift in the balance between the two reflects in large part the decline in value of office property and in rental growth expectations and a consequent rise in the perceived risk attaching to property as an income producing investment. If, as I suspect, we are to see further erosion of the institutional lease structure as the balance of power moves back in favour of the tenant, we could see the gap between property and gilt yields widen still further.

At a time when the market for property is so depressed, I can well understand why there should be resistance from a number of quarters to further inroads into established practices and agreements, freely entered into, such as the terms of the institutional lease, confidentiality clauses and privity of contract.

It seems to me that we must be careful to examine the implications of the various changes proposed and to balance the need for an efficient and open market with other legitimate interests, notably in the certainty and security of existing contracts. There is no doubt, however, that the existence of privity, as it now stands, can have apparently absurd outcomes. It is an example, I suggest, of responsibility without power. By that I mean that a lessee high up in a chain of occupiers can never be free of risk, whilst having no say over actions which change the nature of that risk. This is not the case, I understand, in Scotland where lessees retain some control over subsequent assignments, and it may be that the Scottish approach has something to teach us.

I also believe that market pressures will bring about adjustments to other terms of long-lease contracts, which will bring a better balance between flexibility for users of property and acceptable risk for those who provide the finance. Upwards-only rent review clauses seem designed for a world which had the certainty of an upwards-only pattern of property values. This pattern is not in the interest of the economy as a whole and the thrust of our anti-inflationary policy is intended to make it obsolete.

As the supervisor concerned with the health of the banking system, we have an important prudential interest in the banks' direct exposure to the property sector, but, more widely, to the value of property assets as collateral for a large proportion of bank lending. This downturn is unlike its predecessors in one important respect: overseas banks have played a large part and their share of lending to property companies has more than doubled to over 40% during the 1980s. This additional capacity had, at the time, the effect of reducing margins and lowering the thresholds for credit appraisals. But its consequence now is that property lending is more widely spread across the banking system than before. This has also resulted in a tendency for more banks to be involved in particular developments. Moreover, as I said earlier, institutional investors have been less active in the post-development market and bankers have become reluctant long-term holders of property. We in the Bank of England see many examples of debt restructuring in the wake of breached covenants in the context of the London Approach, which seeks to preserve the value of assets, through orderly workouts and restructuring. With hindsight, the shortcomings of some lending syndicates are apparent. There is general agreement that downside risk was underestimated. I suppose that in every cycle the sufferers learn again the basic lessons—that all lenders must assess risk accurately, and independently from the lead-bank, and price it realistically.

The outlook

I began by reminding you of the text of my previous speech to you. Looking at the condition of today's property market, I should perhaps have been more emphatic in expressing caution. So we all have lessons to learn. If the history of the industry teaches us anything it is this. However bad a downturn may be, however much money may be lost, the balance between the demand for and supply of good buildings of all kinds gradually reasserts itself.

And so I return to the theme of the conference. Although I expect recovery in the sense of the revival of a two-way market, it is not likely to be rapid. Within the property markets, however, there are some encouraging signs of a revival of interest from investors and financiers, not least from some other parts of Europe at present, attracted by a combination of high yields and the low cost of sterling. Nevertheless, it seems likely that tenant demand will remain weak for some time—and oversupply, particularly in Central London, will continue to overshadow the market for a period.

I have no crystal ball in which to see the future of the commercial property market. Liquidity will improve as demand responds to lower prices and a wider economic recovery. Liquidity may also be enhanced at the margin by techniques such as securitisation, but bank finance, institutional funding and, for some, access to the securities markets will remain fundamentally important. Bleakness will not endure: it never has and will not now, though I cannot put a term to it. But we must not allow inflation to be the route by which values are restored.

What else might we do to aid the process? One of the classic obstacles to a perfect market is a lack of transparency. I have been surprised at the relative lack of consistent comprehensive data on the property markets and the apparent lack, until quite recently, of research into the functioning of those markets. The availability of data is limited by many factors but one reinforcing factor is the widespread use of confidentiality clauses. A diminished use of such clauses and a greater willingness to make data available would encourage a more efficient market and aid research and perhaps policy-making. I understand that the Royal Institution of Chartered Surveyors and others are working to correct the present deficiency of serious quantitative research and I welcome this.

Every recession leaves its mark and perhaps this one will produce greater co-operation and understanding between all the professionals, not to diminish their specialisms, but to put into sharper focus once again the long-term interests of the client, for it is these that serve all the others.

Another consequence may be that companies will manage their property assets better. Recent research suggests that this is not currently a matter that commands much attention, even though investing in property requires as active and complex management as for other investments such as equities and bonds. Property investments are generally such an important part of many companies' balance sheets that they deserve the most skilful and professional management.

Property matters to us all a great deal and will continue to do so. It affects us as householders, businessmen, bankers and professionals. We in the Bank have a special role because of our primary interest in breaking permanently the inflationary psychology which has contributed so much to our stop-go performance. This can only be brought about through an appropriate and credible monetary policy. With that in place, the role of property in all investment portfolios, whether of householders or of other forms of collective savings, will be evaluated on its own merits and not as a store of value or as a means of speculative gains which substitute for prudent lending decisions or prudent and balanced savings strategies.

We welcome the opportunity to develop our relationships with bodies such as the British Property Federation, the Royal Institution of Chartered Surveyors and other associations and professional organisations. We all share in the general concern for the prosperity of the property industry and of the whole economy. In the end greater stability will benefit all.