BANK OF ENGLAND

Speech

Risks to the Commercial Property Market and Financial Stability

Speech given by

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Summary

Historically, the commercial property sector has been particularly vulnerable to any cyclical deterioration, with knock-on effects to the wider financial system. In recent years commercial property prices have risen sharply, accompanied by a rapid increase in bank lending to the sector. Yields have fallen to historically low levels. But although there are similarities with previous booms, including sharp price rises, there are also important differences, including the benefits of continued financial market innovation. Against this background, it is prudent to monitor market conditions closely and to stress test portfolios against adverse outcomes.

1 Brief recourse to the history of Brighthelmstone, or Brighton as we now know it, reveals a turbulent past. In 1514, the town was burnt to the ground by French raiders, whilst 1703 saw many houses washed away during a great storm. In 1984 the world was shocked when IRA activists bombed the Conservative party conference in this hotel. And most recently it has seen the demise and gradual collapse of the iconic West Pier, which was finally declared beyond repair just over 2 years ago. Yet against this background, the town has been transformed from a small fishing village to the highly fashionable city we find ourselves in today. This picture of rapid growth punctuated by occasional major, adverse events is closely related to the topic I wish to discuss today.

2 The commercial property sector has a similarly turbulent history, at least over the most recent past. Periods of sharp and dramatic appreciation in capital values have been frequently followed by periods of significant decline. And, in several cases, these episodes have been associated with wider financial system stress. The early 1990s crash in the commercial property market, which contributed to the wider economic downturn, was precipitated by rapid price and lending growth not dis-similar to that in evidence today. During this downturn, 25 of the so called ‘small banks’ either closed or failed.[2] And stresses in the commercial property sector have also contributed to broader financial strains in other countries for example in the US in the early 1990s and more recently in Japan.

[2] See A Logan “The early 1990s small banks crisis: leading indicators. Bank of England *Financial Stability Review* December 2000.

3 As you know, current market conditions are very buoyant, with recent returns substantially higher than the long term average and defaults on commercial mortgages infrequent. Given the historical experience, it is valuable to stand back and consider whether such buoyant conditions are leading to an increase in risks which could trigger a rapid change in market sentiment and broader financial strain at some point.

4 At the Bank we focus on achieving monetary stability and financial stability, which together constitute our two so-called 'Core Purposes'. The achievement of monetary stability centres around the setting of interest rates on a monthly basis by the Monetary Policy Committee in order to meet the inflation target set by the Chancellor. And with our colleagues at HM Treasury and the FSA we work to maintain financial stability through the tripartite Standing Committee on Financial Stability.

5 The setting of monetary policy is necessarily forward-looking given the speed with which changes in interest rates impact on the economy. So it is expectations of how the macroeconomic environment will look in the medium term that determine current interest rates. And the macroeconomic outlook is relatively benign at present.

6 Within our financial stability remit we focus primarily on downside risks. In particular, we look for whether there are vulnerabilities or weak points in the financial system that could, in unlikely but nonetheless plausible circumstances, generate serious disruption to either financial markets or to the financial system more broadly, with potentially widespread economic costs. In addition to improving the tripartite Standing Committee's knowledge of these risks, we hope, through publications such as the Bank's regular *Financial Stability Report*, to help financial firms and the wider public in managing and preparing for these risks. Where appropriate, we work with the FSA, HMT and other authorities to improve the robustness and resilience of the UK financial system. And we also work on strengthening contingency planning and crisis management arrangements in preparation for the worst, should it occur.

7 As I mentioned earlier, commercial property has proved a source of instability in the past and is an area we monitor closely. Chart 1 shows the volatility of price movements in the past and also highlights recent rapid rates of price growth (close to 15% annually in nominal terms), which have not been accompanied by a coincident

increase in rental growth. Indeed the pace of price appreciation recently has driven yields to an historic low of 5.5%, almost half the level witnessed in the early 1990s (Chart 2). And, though the quantity of city office developments has fallen over the past three years, the quantity of development in the pipeline for the next three years is considerably higher (Chart 3), but still below the level seen during the late 1980s / early 1990s.

8 While the sustainability of these trends is of natural concern to those active in the commercial property sector, the apparently exaggerated buoyancy of the market would not be viewed as a potential source of risk to the UK financial system as a whole if the market were small in financial terms. But as we know, this is not the case. UK banks' lending to the commercial property sector has risen rapidly in recent years, increasing by more than 15% during the past year and quadrupling since 1997. The sector now accounts for over a third of lending to private non-financial companies (or PNFCs), twice the proportion of seven years ago (Chart 4). And property is also an important asset class for pension funds, insurance companies and other investors. So the fortunes of both investors and lenders have become more closely intertwined with the fortunes of the property sector over the recent past.

9 Of course, the key question from a financial stability perspective is 'how likely is a market correction?' In order to answer this question it is necessary to understand the forces behind recent market developments.

10 The past few years have seen large increases in asset prices in a number of markets. As discussed in our most recent *Financial Stability Report*, this may partly reflect a manifestation of the generalised 'search for yield' in the face of low interest rates and wider macroeconomic and monetary stability. The increase in the quantity of money being invested in markets in search of higher returns has acted as a catalyst for financial innovation, evidenced by rapid growth in securitisation activity and in structured credit markets more generally. From a financial stability perspective, the broadening of the investor base both domestically and internationally associated with the development of new credit transfer products and the introduction of increasingly sophisticated investment vehicles has resulted in a beneficial diversification of risk. A good example are real estate investment trusts, or REITs, whose securities are bought and sold on the major exchanges and therefore provide an accessible, liquid,

property investment instrument. By extending commercial property investment opportunities to a much larger community of investors, whilst simultaneously minimising the concentration of exposures to individual investments and increasing trading opportunities, the introduction of REITs can be seen as a positive development from a financial stability perspective. And these structural developments, which have widened the investor base and increased commercial property demand, also help to account for some of the increase in prices. Banks' risk management practices have also improved in recent years, with closer monitoring of loans and greater use of stress testing. So a number of factors may have reduced the likelihood of a sharp correction of the type experienced in the early 1990s.

11 That said, the extent to which recent trends have affected potential market dynamics in the event of a rapid change in market sentiment is yet to be seen. For example, the recent growth in securitisation activity within the commercial property sector may have reduced the probability of stress on account of the associated diversification in risk, but if strain in the sector were to occur then uncertainty over where the underlying credit exposures actually lie, and how 'new' investors will behave if their tranches are downgraded and/or they suffer credit losses, could make it more difficult to resolve.

12 And there are questions as to whether the generalised 'search for yield' has gone too far and led to a potential under-pricing of risk in some asset markets. Certainly it is doubtful whether the structural changes described above can explain all of the recent increases in price growth, which have led to valuations becoming stretched in relation to their traditional determinants. The dividend discount asset pricing model provides one decomposition of the factors behind the increase in the rate of growth of capital values. As shown in Chart 5, the compression in our estimate of the risk premium has been one important factor. Another has been the fall in the discount rate: over the past year, the 10-year real government bond yield has fallen to its lowest level since index-linked gilts were first issued 25 years ago. And these trends may be partly related: low bond yields have encouraged investors seeking a given nominal return to invest in riskier assets – including property – driving up their price. Although the model is simplistic and has clear limitations, the

analysis also suggests that property prices could be at risk if bond yields were to rise and/or investors' risk appetite to fall significantly.

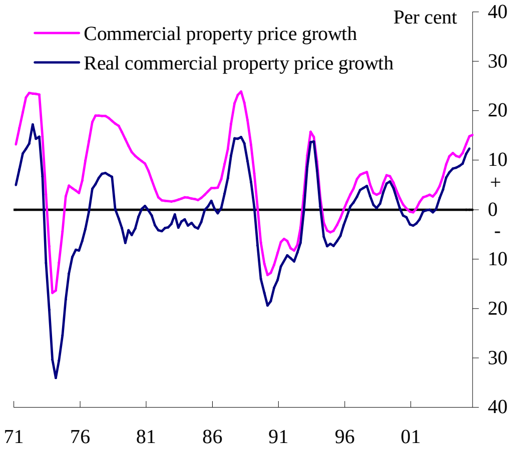
13 From a risk management perspective, the potential for a sharp adjustment should not be overlooked. Not least because fortunes within the commercial property sector can rapidly reverse, as I am sure you are all too aware. This is demonstrated by the fact that the fraction of quoted property companies making a loss rose from zero to almost 30% between 1988 and 1992. And whilst the risk environment is clearly different now to then, it is important not to ignore the lessons of economic history. This is particularly important in a market such as commercial property, as experience of past episodes of stress in the sector becomes increasingly limited among active market professionals and anecdotal evidence tells us that new investors may be tending to over-extrapolate recent trends. Although unlikely, it is prudent to be prepared for severe adverse shocks either to the macro-economy or to financial markets. These could trigger a sharp change in market sentiment and involve an abrupt end to the 'search for yield' phenomenon mentioned above. This in turn could lead to a marked change in financing conditions, with commensurate falls in property prices and difficulties in refinancing. The accompanying reduction in risk appetite would tend to result in a rapid widening of credit spreads and reduce the liquidity of some new capital instruments. By way of example, it is worth noting that US CMBS spreads jumped by more than 90bp in the two months following the announcement of LTCM's failure in September 1998.

14 Again, I wish to emphasise that such a scenario is improbable and does not reflect our beliefs about the most likely outcome for the commercial property sector. But it is sensible to consider adverse outcomes and to stress test portfolios when managing risk exposures.

15 Clearly the world has changed somewhat since we last witnessed significant stress in the commercial property sector. The main developments – greater macro-economic stability, and innovation to improve the capacity to manage, hedge and diversify risks should I believe be viewed in a positive light from a financial stability perspective. And as I outlined earlier, the central macroeconomic outlook is benign at present, with risks on both sides broadly balanced. Nonetheless, the exceptional buoyancy of recent conditions in commercial property markets and the associated rise in leverage

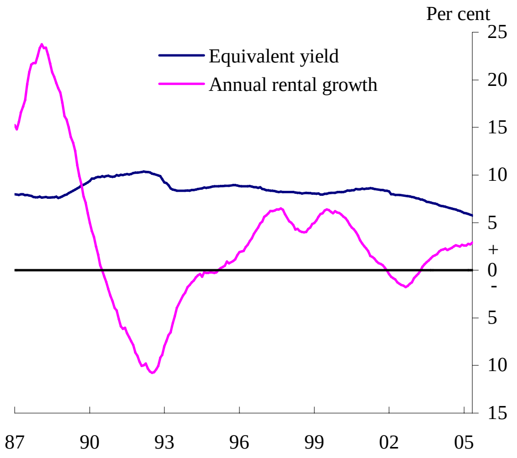
do suggest some build up in vulnerabilities, and so warrant careful risk management by market professionals.

Chart 1: Commercial property price growth, 1971-2006[3]



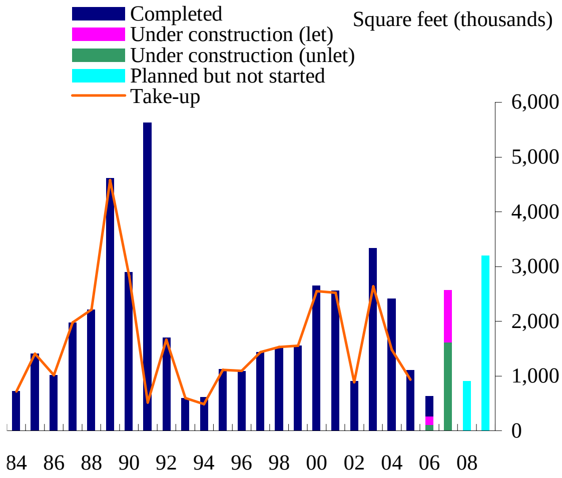
Source: Investment Property Databank and Bank calculations

Chart 2: Equivalent yield and annual rental growth, 1987-2006



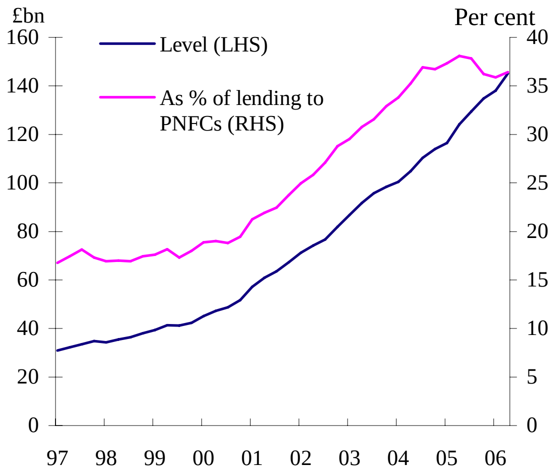
Source: Investment Property Databank

Chart 3: Development pipeline – city offices, 1984-2009



Source: CB Richard Ellis

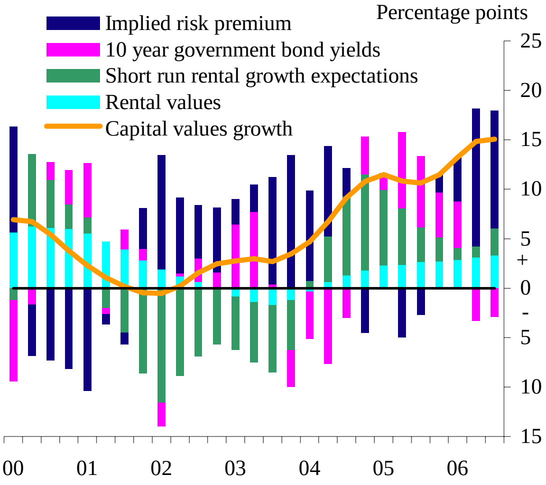
Chart 4: UK banks' lending to the commercial property sector, 1997-2006



Source: Bank calculations

3 A measure of real commercial property prices is obtained by dividing the IPD All property capital values index by the GDP price deflator.

Chart 5: Dividend discount model decomposition of commercial property price growth, 2000-2006



Source: Investment Property Databank, Investment Property Forum and Bank calculations

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