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Speech

Property booms, stability and policy

Speech given by
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It is a great privilege to be invited to give this lecture in honour of Alastair Ross Goobey.

Alastair Ross Goobey spent much of his career as a fund manager, becoming best known as chief executive of Hermes from 1993 to 2001. He used that position to champion shareholder activism and to campaign for improvements in corporate governance. He was also an author, on investment management and property. There is a telling passage from the introduction to 'Bricks and Mortals':

> *"...collective myopia .. affects all markets from time to time. Few indeed have been those who invested at the bottom and sold at top. Mistakes were made, not dissimilar in size and form to those made in previous cycles. I doubt whether this book will prevent similar mistakes being made in the future, even though the lessons and opportunities are clearly here to be read."*

When he wrote that in 1992, UK commercial property prices were down 25% from their peak. Less than 20 years earlier, the Bank of England had needed to launch its 'Lifeboat' to contain the UK's secondary banking crisis caused by a property market collapse. Twenty years later, UK commercial property prices are down over 30% following yet another credit-fuelled bubble.

Ross Goobey's pessimism about the future was, therefore, warranted. This should be sobering – for us all. I am going to say something this evening about some of the lessons for bankers, the property industry, and policymakers.

The commercial property boom and bust

Those lessons are by no means for the United Kingdom alone. This latest property boom and bust went well beyond these borders.

A few examples will suffice. At their peak in 2006/7, Irish commercial property prices were up 70% on the turn of the century. As in the UK, the rise in Spain was around 50%. In Portugal and the US, 40%. All that quickly unwound when the bust came. US prices hit a trough in 2009, falling almost 40% in just 18 months. In Ireland it was uglier still: prices continued to fall through 2010 and 2011, to less than 40% of their peak. In Spain and Portugal, prices have been stickier, with only a 20% fall in recorded valuations so far. But real-estate problems continue to surface in more than one country. This might well not be over, I fear.

In many of those countries, but not all, there was a construction boom. In Ireland and Spain, the share of construction in GDP rose by 2pp over 5 years. This may have driven headline output growth above trend, with inflation contained partly by downward pressures on wages from China's entry into the world economy. Current account deficits mounted, which can be a symptom of repressed inflation since they amount in effect

to borrowing foreign supply capacity to sustain local demand. But even where aggregate demand was not on an unsustainable trajectory, resources were misallocated. That is tragically apparent from the overhang of vacant properties – residential and commercial – in some economies when the bubble burst.

In almost every economy, there was a lending boom, fuelled by lax credit conditions – especially in property markets. Commercial banks in many countries have had to be recapitalised already. In some, that lies ahead. Credit conditions have tightened appreciably, arresting economic recovery and, in countries like the UK, impeding the rebalancing of the economy's productive capacity.

Some tough lessons follow.

Commercial banking can be risky too

First, it seems to me likely that, even without the excesses in investment banking, the West would have suffered a commercial banking crisis brought about as a property boom turned to bust. In his report into the supervision of RBS, Adair Turner points out that the bank lost more on straight property lending (in the UK, Ireland, and the US) than on super-senior tranches of ABS and CDOs[1].

For me, this highlights how the 'casino versus utility' metaphor can apply to all kinds of banking. An investment bank that makes markets in US Treasuries and the S&P 500, and has a corporate finance advisory business, underwriting high-grade equities and bonds, can be pretty low risk. A highly levered commercial bank that runs a concentrated portfolio of loans to highly geared property investors, funded short-term from the wholesale money markets, is likely to be pretty high risk. A bank does not need to do anything fancy to be high risk.

How threatening that is to the system as a whole depends on how much of it is going on; how intertwined the system has become; whether risk is pervasively underpriced; and, perhaps most crucially, how thinly capitalised the banking system (including shadow banking) is.

This is why policymakers, internationally, are introducing new constraints on bank leverage; are re-examining limits on large exposures within the financial system; and in many jurisdictions are putting floors under the capital requirements derived from banks' own internal models. I could go on, but this is not meant to be a rehearsal of the G20 reform programme.

In the UK, debate continues on how the prudential regulator can ensure that the collective effect of banks' CRE models is not stability-threatening. While the FSA accepts that changes might sensibly be made to

[1] See section 1.3 and 1.4 of 'The failure of the Royal Bank of Scotland', Financial Services Authority Board Report (2011).

their initial proposals on what is known as 'slotting', their objective of prudent valuations and capital allocations is surely shared by all.[2]

Industry concentrations can exacerbate the costs of systemic crises

The second broad lesson I want to highlight is that the effects of bank failure or distress can be greater when the industry is concentrated.

Domestically in the UK, recovery has been impeded by the fact that the banks worst hit by impairments in property and leveraged-loan portfolios were also the banks that were previously most important to business lending. The businesses making up LBG and RBS accounted for over 40% of the stock of lending to UK firms in 2007.

This underpins the case for reducing barriers to entry into banking in order, over time, to generate more diversification in each of the key segments of the market. The Bank of England and the prudential supervisors at the FSA, led by Andrew Bailey, are committed to delivering lower barriers to entry.

We believe that a useful step to lowering barriers to entry will be to lower barriers to exit.

New banks start life without a track record; without a solid deposit base or a lending franchise. Other things being equal, they are more likely to fail than other, similar but established banks. That makes it natural for the individual line supervisors authorising new banks to be cautious if they think that failure will be disorderly.

But that is why the UK has a system of deposit insurance for deposits up to £85,000; and it is why, since 2009, we have had a special resolution regime under which, once the prudential supervisor concludes that there is no other solution, the Bank can resolve a distressed deposit-taker without recourse to standard corporate bankruptcy proceedings. Prudential supervisors can place weight on those parts of the overall regime when assessing applications to set up a deposit-taker. In other words, alongside honesty, integrity and the capability to manage the firm prudently, the resolvability of the business if it gets into distress matters for authorisation. That should not be a massive hurdle for simple businesses.

Over time, this should help to reduce concentrations in particular lines of business. But it might not be enough. The competition authorities care about this because of the quality of services provided during peacetime. But the stability authorities also need to be more alert than in the past to this source of vulnerability, because it affects the economic costs of distress at individual banks.

[2] Under so-called 'slotting', banks' internal models are not used to generate capital requirements. Rather, CRE loans are capital-weighted according to how they are assigned to one of four risk buckets, under criteria set by the FSA.

Monetary policy affects the appetite for risk

A third area for lessons concerns the effects of macroeconomic policy. Policymakers must not blind themselves to the fact that, sometimes, persistently easy monetary policy can fuel exuberant credit conditions.

It is commonplace to say that the appreciation in asset values, including property, was a consequence of the pronounced fall in global risk-free interest rates driven by surplus Asian savings. That this did cause asset prices to rise I have little doubt. But yields on property fell a lot more than long-maturity risk-free rates of interest. The initial impulse to values got out of hand, through a search for yield, an associated extrapolation of *ex post* returns into *ex ante* targets, and myopia about the risks given years of undisturbed growth.

But there were marked variations across and within countries. In Germany, property prices were basically flat to gently falling in the seven years up to 2007. In the US, prices rose sharply. But while they more than doubled in Florida, in Michigan they were up only 20%, less than one would expect given the rise in the US's nominal GDP.

Local planning laws, demographics and incomes will have made a difference. But so, surely, will local credit conditions.

The euro-area illustrates this well, including today. In the run up to the crisis, with one area-wide monetary policy rate and the market not differentiating between countries' government bonds, credit conditions were far too lax in a number of countries, including Ireland, Spain and Portugal. These were countries enjoying 'catch up' in incomes and, potentially, productivity, which one would expect to be accompanied by relatively buoyant credit growth. But it got completely out of hand; and their local macroeconomic authorities had few tools they could use to lean against the wind.

Credit conditions in those countries are now crushingly tight. But, interestingly, they are arguably now loose in Germany.

As I argued recently with my Bundesbank colleague Andreas Dombret[3], this makes the case for each country to have a macroprudential authority with the capacity and flexibility to vary capital, liquidity and margining requirements to underpin the resilience of the financial system in the face of heady credit conditions.

[3] Blueprint for resolving regulation, by Andreas Dombret and Paul Tucker. Published by the Financial Times on 20 May 2012 and also available online at http://www.bankofengland.co.uk/publications/Documents/speeches/2012/speech580.pdf

It also underlines the importance of monetary policymakers assessing the effects of regulatory regimes and measures on credit conditions and the monetary transmission mechanism.

Policy now: liquidity regulation, monetary policy, and central banks' liquidity insurance

I have been thinking about this recently given the possible interactions of the Bank's Quantitative Easing operations, the FSA's liquidity regime, and bank lending conditions.

Let me begin with QE.

The first round of QE was initiated, in early 2009, when the domestic banking system was, to all intents and purposes, broken. The Monetary Policy Committee did not think that our stimulus to aggregate demand could rely on easing bank lending conditions. On the contrary, we aimed effectively to side-step the banking system by putting money directly into the hands of long-term investment institutions by buying gilts from them. Because they would not want to give up the duration benefits of holding gilts, we would have to pay up, driving down gilt yields. That helped to support the value of other asset classes. And because money was yielding next to nothing in real terms, we thought that they would try to get rid of the money by buying other assets, including sterling corporate bonds. That happened. More companies have issued sterling bonds over the past three years than previously. Such firms used the proceeds of their bond issues to repay bank loans. This was benign deleveraging. It meant that buoyant broad money growth was not, in my view, an acid test of the success of QE in its initial phase.

That was when the banking system was broken. Since 2009, many banks have made good progress in repairing their balance sheets. We should have reached a position where, in the language of the Monetary Transmission Mechanism, the 'bank lending' channel is switched on to some extent.

That is all the more important to recovery because both households and small and medium-sized businesses are reliant on banks for loans and credit facilities. It is, therefore, serious that bank lending growth has, in aggregate, remained so weak.

There are many reasons for this.

Some borrowers are now risky due to the restructuring underway in parts of the economy and the working off of legacy debt burdens. I fear parts, but not all, of the property sector may fall into that category.

Some firms are themselves reluctant to accumulate debt to finance new projects given the uncertainties facing the economy, which have been badly exacerbated by the challenges facing the euro area.

A principal channel through which that is happening is increased funding costs for banks. Notwithstanding the progress many of them have made in replenishing capital, there is no amount of capital reasonably available to them that will reassure the markets that they could withstand the most extreme tsunami if the euro area were to unravel. However unlikely that scenario, the market regards it as a tangible possibility. An event with low probability but gigantic impact affects bank funding costs. That is gradually being passed on into lending rates for firms and households.

The banks themselves did not bring about the underlying challenges facing the euro area. Given the costs to our economy, the authorities, including the Bank, need to consider what more we could do to alleviate tight credit conditions in the UK.

We also need to challenge ourselves on regulatory policy – on capital and liquidity.

On capital, my view has been that, with the worst still possibly ahead of us rather than behind us, banks should take what opportunities they can to build their resources. In the event of a tidal wave rather than a tsunami, we might all of us – banks and their stockholders, as well as the authorities – be grateful for a few extra billion making the difference to firms' survival. Crucially, as and when the threat of crisis recedes, the banks' capital planning should return to normal, with Basel 3 not having to be achieved until towards the end of the decade. To be clear, the Financial Policy Committee has not changed the UK's deadline for Basel 3 compliance, but has encouraged banks and regulators temporarily to bolster capital adequacy while conditions exceed anything contemplated by the Capital Accord's framers.

Liquidity is, perhaps, different. Central banks need to stand ready to provide liquidity to see the banking system through stressed conditions – without strings attached when the source of the stress is beyond banks' control. Accessing such facilities is perfectly normal.

That being so, there is less of a case for regulators to require banks to rebuild their stock of liquid assets in current conditions. At the least, banks need to be free to draw on their liquidity buffers in order to absorb current pressures. And, so far as possible, we should see whether we can liberate this part of their balance sheet in these stressed times. Whether we can do so may turn on whether the binding constraint comes from regulation or from the market.

Were that achievable, it might be helpful to the operation of monetary policy. Through its QE purchases of gilts, the Bank has injected a huge amount of reserves into the system. The regulatory liquidity requirement might be operating, inadvertently, as a de facto reserves requirement. If so, our supply of reserves is in part meeting a regulation-inspired increase in demand for reserves, leaving less than we have injected free as a 'masse de manoeuvre' for the banks to deploy in expanding their loan books. I am conscious that that is rather old-fashioned monetary economics. But these are times in which the interactions of regulatory policy,

central bank liquidity-insurance facilities, monetary policy and debt management need joined-up analysis. The issue needs to be thought through. That is part of what central banks are for.

Conclusion

There is much to be done – by firms, bankers, regulators, and central banks. Much to be done over the medium term to build a safer world; and much to be done to ensure that we get there in one piece. I fear that, with the external threats so great, the domestic authorities do not have anything like a magic wand. Joined-up thinking will help us make best use of those instruments that we do have.

And when we get through this, as we shall, all must remember that exuberance in illiquid property markets can be especially threatening to the economy's health. It is possible for banks to support the industry, and the economy generally, without putting stability at risk. Given the financial markets' inherent inclination to excess, policymakers must be ready, next time, to take away the punchbowl. The Bank's new Financial Policy Committee is being created to do just that. It won't always be popular, but it will sometimes be necessary. And I don't doubt that, sometimes, people will say that we acted too soon or unnecessarily. So, to conclude, a plea. Please remember Alastair Ross Goobey's wise words when the time comes.