



BANK OF ENGLAND

# Speech

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## **Nurturing resilience to the financial cycle**

Speech given by

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I am grateful to Martin Arrowsmith, Oliver Burrows, Neil Crosby, Kishore Kamath, Magda Rutkowska and Robert Sturrock for their assistance in preparing these remarks.

My Lord Mayor, Lady Mayoress, Ladies and Gentlemen.

It is a great honour to join you this evening.

It's clear why you are celebrating.

A crane-filled skyline to the City.

New office space completion in Central London: a ten-year high;

More than thirty schemes underway: a twenty-year high;

And transactions that are near a record high.

Half of them financed by capital attracted from overseas.

Commercial property is punching well above its weight in attracting capital to Britain. Those capital inflows are helping to sustain steady growth while our major trading partners lag behind.

So your industry is contributing to the livelihoods of people up and down the country.

But while that's true in the good times, it's true in the bad times too: when commercial real estate catches a cold, the whole economy starts to shiver.

It's not just that the construction industry suffers and jobs are lost, or that banks are injured, impairing their lending to the rest of the economy.

It's that small businesses see their own property fall in value – assets that are vital to secure their borrowing.

And if the flow of foreign capital were to dry up or even reverse, there would be wider consequences for spending, output and exchange rates.

So your continued success is important to everyone.

And yet, as you know all too well, the UK's commercial property market hardly has a record as a beacon of stability.

But we shouldn't be fatalistic. We're not doomed to repeat the past.

Yes, the cycle is a force of human nature.

But resilience to it can be nurtured.

It will be a battle of nurture against human nature.

The time to start it is when people most feel like celebrating: when your market is on the up. We have to start now.

And if we're going to have any success, we - the Bank of England, you - the industry, and us - together, need to step up and act.

So this evening I want to set out what is being done.

At the heart of it is the need to ensure finance supports you through the whole cycle.

The need to avoid the pattern - all too familiar to you - of financing conditions going from conservative to careless and then to completely closed, all too rapidly.

The need to replace financing that magnifies cycles of sentiment with financing that mutes them.

And in this, the measures I'll outline this evening constitute one aspect of a broader post-crisis endeavour to build, and maintain, a financial system that supports, and does not disrupt, the real economy.

It goes by the name of macroprudential policy.

### **Banking system resilience**

The first step to nurturing a resilient environment is to reduce the prospect of a sudden crunching of credit supply from an injured banking system.

In the financial crisis, as banks were holed below the waterline and new lending seized up, the flow of new lending to commercial property collapsed to a third of its earlier level.

Since the crisis, the Bank of England has been building a safer banking system.

Measured on a consistent basis, major banks hold 10 times more capital than they did before the financial crisis<sup>1</sup>.

And through stress testing, we're making sure they're able to withstand severe stresses. By withstand, I don't just mean survive. I mean continue to lend, including to you.

Last year, we tested whether the banking system could withstand a snap back of long-term interest rates, a sharp fall in residential and commercial real estate prices, and a deep recession - all without cutting lending.

This year we're testing whether they can withstand a synchronised, sharp slowdown in China, emerging markets and Europe, and sharp falls in asset and commodity prices – all while increasing lending to the UK real economy by 10%.

We showed last year that, where the tests say a bank needs more capital, we're prepared to take action.

And where the system needs strengthening as a whole, we can change capital requirements to put additional resilience in, either across the board through countercyclical requirements, or to particular sectors, through sectoral capital requirements.

We are matching the strength of the banking system to the scale of risk it faces, so you can be more confident that credit will be there when you need it.

### **Resilient underwriting standards**

We have to nurture more than the resilience of the banking system.

Your balance sheets have to be resilient too. Over-gearing of your industry has been a major driver of instability in the past, making you vulnerable to the slightest change in sentiment.

In part that's the result of lenders offering deals in the good times that present even the most responsible investors with an impossible choice: gear up to uncomfortable levels or be forced out of the market.

To avoid that Hobson's choice, any slipping of lenders' standards has to be addressed. That's why we're now reviewing the standards of major lenders regularly.

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<sup>1</sup> Carney M (2014) "The future of financial reform", presented at a Monetary Authority of Singapore Lecture, November 17, 2014

This year we found loan-to-value ratios rising and interest cover ratios falling, but from a very conservative starting point. We'll keep watching this, and there will be a new survey in coming months.

We know that the importance of major UK lenders in financing you has almost halved since the crisis.

While that diversity should be welcome – it should be a source of strength – it can be a source of weakness if it simply moves gearing into a shadow on our radar screen. It's essential that our radar technology keeps up.

The Bank's Commercial Property Forum, ably chaired by Ian Marcus, helps us minimise the shadow on the screen. But we also want systematic data. That's why I welcome the efforts of your industry, in partnership with us, to build a database of CRE loans: a dataset that will be run and managed for the public good, while respecting commercial confidentiality.

It can give you, and us, the information we need to manage the risk of loosening underwriting standards.

### **Long-term valuations**

But still more is needed to nurture a resilient market environment. You can become over-gearred without technical slipping of underwriting standards.

We've seen in the past how a change in sentiment can drive commercial property prices up even without the prospect of improvement in the cashflows which the property will generate.

That creates headroom for those already in the market to borrow more without breaching their loan-to-value standards. And the use of that headroom drives prices up further.

An ultimately pernicious spiral of sentiment and debt begins. Valuations and debt increase sharply relative to the cashflows that support them.

When the music stops, the process goes into sudden reverse. As valuations fall, borrowers are left struggling to service loans that are greater than the value of the property.

Firesales begin. Sentiment deteriorates. And market valuations collapse.

In short, finance magnifies the cycle.

This is detrimental to you, to lenders, and to the rest of the economy. And to your great credit, your industry has been in the vanguard of thinking to deal with this.

The proposal of the cross-industry Vision for Real Estate Finance, led by Nick Scarles of Grosvenor, was that everyone - lenders, borrowers and regulators - should consider appropriate levels of debt not relative to market prices but relative to cash flows capitalised at long-term, cycle-neutral, rates.

Put simply, if prices rise because of sentiment rather than cashflow prospects, that should result in greater reliance on equity, rather than debt, finance.

So when the inevitable reverse in sentiment happens, it won't be magnified by an over-indebted industry.

The industry proposal is music to our ears. If you apply it, it will stop debt running away unsustainably in the good times. And it will cushion the bad times.

It's countercyclical, mirroring the way capital requirements for banks will now operate.

And it's completely in tune with the broader aim of reducing the way finance magnifies cycles.

So we want to help you make progress with it. As capitalisation rates come down from their post-crisis highs, the need to do so is increasing.

So in a matter of months, the Bank of England will start reporting market-wide indicators of valuations and gearing based on cashflows capitalised at cycle-neutral rates.

It will help you to measure the risks. And risk that gets measured can get managed, by you and by us.

These measures aren't a panacea. They can't guarantee occupancy rates or rents for you. But had they been used to guide your decisions and our policy, they would have made a real difference in the run-up to the crisis.

In fact, the last commercial real estate cycle could have been severely curbed and loss rates for some banks dramatically reduced.

So your industry really does deserve great credit for taking the lead in developing the answers. Now – when you most feel like celebrating – is the time to start applying them.

### **Resilience in the future**

If we continue to work together there is a real prospect of nurturing a market that keeps up with the cycles of human nature.

But nature will fight back. The drivers of cycles will evolve. History may rhyme, but it rarely repeats.

Just look in this cycle at the rapid inflows of finance to commercial property from retail investors in open-ended funds. More than 6% of the stock of commercial real estate finance is now held in these funds, and is growing rapidly.

Now, a shift in finance, from bank debt to fund equity can be good for stability. It's one part of the broader inflow of equity in this cycle, which is helping to keep gearing down as prices rise.

But it's not risk free. Fund investors offered redemption at short notice can create problems if prompted to herd to the exit.

In the 2008 crisis, we saw redemptions from property funds reach more than one half of assets under management. Many of you saw the consequences – firesales of assets, magnifying the market downturn.

Open-ended property funds now have 80% more assets under management than they did on the eve of the crisis.

So the growing importance of funds offering short notice redemption and investing not just in property but in other potentially illiquid markets too, is a focus of regulators in the UK and internationally.

The Bank of England, along with the FCA, is looking closely at the ways these funds might contribute to broader instability.

And it's in part thanks to working closely with you that we're alert to this.

By working together, our nurturing of resilience can keep up with nature's inevitable fight back.

We can together create an environment that gives you the best chance of success. Whether you succeed will be down to you. But one thing is for sure. Your success is important to everyone.

For its part, the Bank of England is committed to ensuring the financial system serves you – the real economy.

That's why, here at Guildhall, in 23 days' time, we're hosting an Open Forum to bring together policymakers, financial market users, academics, and wider society.

The aim is to chart the way for financial markets so that they serve their users and contribute to prosperity.

You can sign up on our website.

Please do. Because your industry has taken a lead in learning from the past, in leading the changes needed and in having a sense of your responsibility to the wider economy.

Yours is a model of engagement for others to emulate. And I look forward to continuing to work together.

Thank you.