BANK OF ENGLAND

# Speech

## "Property and the Economy"

Speech given by

David Clementi, Deputy Governor of the Bank of England

At the Chartered Surveyors' Livery Company International Dinner, Goldsmith's Hall, London

29 April 2002

## Introduction

Property markets, both residential and commercial, are of perennial interest for the Bank of England. Why? Because they are, at the same time, barometers of economic conditions and potentially also the source of financial risks; and even, in extreme cases, financial crises.

I will start by saying a little more about the reasons for the Bank's interest in property, go on to discuss some medium-term developments in property markets and end with a few comments on current property issues and their implications for the broader economic policy debate.

## Why the Bank takes an interest in the property market

The first and most familiar of the Bank's three Core Purposes is to maintain the integrity and value of the currency. In practice, this translates into achieving an inflation target of 2½% per year on the RPIX measure. This target is set annually by the Chancellor, and it was reaffirmed in the Budget speech earlier this month. It is the task of the Monetary Policy Committee, which meets each month, to decide on the level of interest rates needed to deliver this result.

Our other two Core Purposes are perhaps less well known, but complement that of monetary stability. They are: to maintain financial stability of the system as a whole, both domestically and, so far as we can contribute, internationally; and to ensure the efficiency and effectiveness of the UK financial system in supporting the rest of the economy.

Property markets are relevant to all three of our Core Purposes. They are, first of all, very large markets, so that property lending and investment are important elements in banks' and fund managers' portfolios. Residential mortgage lending, for example, currently totals around £600 billion. Bank lending directly to commercial property companies amounts to a further £60-70 billion, while total commercial property lending, direct and indirect, may total more than £200 billion. With numbers like that, the potential for upsets in the property market to cause problems for the banking sector are clear. We have seen this in the past, when poor lending decisions and high levels of property-related debt have led to strains on UK banks and even threatened the financial system as a whole, most notably in the fringe banking crisis of the mid-1970s. Aside from the risks for the financial system, movements in property values can have important macroeconomic effects, exemplified by the well-established links between house prices and consumer spending.

**How the Bank gets its information about property**

In carrying out its monitoring and analysis, the Bank draws on a wide variety of information sources. On the residential side, these include the Royal Institution of Chartered Surveyors, the Council of Mortgage Lenders, and some major individual lenders such as the Halifax and Nationwide, both of which of course publish well-known house price indices. On the commercial side, information is less readily available, and less easily assembled into an overall picture. It was partly for this reason that, following the property-related problems of the early 1990s, the Bank established its Property Forum. The Forum brings together representatives of investors, lenders, occupiers, and researchers, as well as officials from the Bank, HMT, the FSA and DTLR. The Forum meets quarterly, and is currently under the chairmanship of Clive Lewis, a past president of the RICS. Its work is supported by a regular round of liaison meetings with lenders and other participants in the property market. This helps us to monitor current developments and to identify underlying structural issues.

I would like to highlight four of these issues, which may, at least over time, affect the way that we think about the property market.

**More limited role of public equity finance**

The first is the reduced reliance of property companies on public equity finance, where the facts I think are clear. The number of quoted property companies has fallen by 40% over the past decade. Public-to-private deals in the commercial property sector accounted for a fall of £4 billion in the value of quoted equity in 2000 alone, according to DTZ research. And the proportion of pension fund and life assurance assets allocated to property has fallen from around 15% twenty five years ago to a little over 5% now.

The attractiveness of publicly quoted equity for property companies has always been limited by the fact that it tends to trade at something of a discount to other issues, reflecting the rather special characteristics of the underlying market – relatively low liquidity, relatively high transaction costs and the 'lumpiness' of most property transactions. But the trend away from public listing probably also reflects a greater perceived attractiveness of debt finance. The large positive yield gap between property returns and borrowing costs reflects both the decline in official interest rates, and the reduction in lending margins as competition for business has risen, fed in part by an increased involvement of banks from overseas. Bank lending to the property sector has grown rapidly in recent years, and I want to return to the implications of this for both monetary and financial stability shortly.

**Financial innovation in commercial property**

The second structural trend I want to highlight is the heightened pace of financial innovation in the commercial property market. Much of the motivation for this has reflected a desire to take property off balance sheet, and in this firms certainly seem to have been successful. Direct holdings of property by private non-financial companies fell from just under half of their fixed assets in 1995 to just over a third in 2000.

This has been achieved using a number of techniques, including sale and lease back, equity investment vehicles (principally limited partnerships) and securitisations (which create a tradable interest in a pool of property assets). Of these, the take up of securitisations in the UK remains rather modest when compared to the US, in part reflecting differences in market structures, fiscal and legal regimes. But the market is well developed compared with that in the rest of Europe (UK structural finance issues for example accounted for some 35% of the European total last year). And there appears to be considerable scope for further growth in the medium term, though a rapid expansion is perhaps unlikely in current market conditions, in which margins are judged by some observers to be rather thin.

Other forms of financial innovation in the commercial sector, such as property-related derivatives, have so far proved less popular. There may be an element of 'chicken and egg' to this: an active derivatives market typically depends on, but also contributes to, an active secondary market in the underlying asset. One aspect of the problem is the reliance of proposed derivatives on property indices, which given the illiquidity of the secondary property market must often be based on professional valuations rather than traded prices. This in turn raises various questions about the reliability and objectivity of the valuations, and about whether they lead or lag such market prices as are available. In this context development of the Investment Property Databank indices is encouraging; but it is of course for the industry to decide whether alternative or better indices might be constructed.

Assessing the impact of financial innovation on the degree and incidence of financial risk is a crucial aspect of the Bank's financial stability role. New instruments and structures have the potential to deliver a better match between borrowers' and lenders' preferences. But they can also mean that better quality assets leave banks' balance sheets, so that the remaining loans are of lower quality. And the variety and complexity of deals raise issues about whether the risks are always fully understood by all the parties involved.

**Changes in the financing of residential property**

My third theme relates to the residential sector, and specifically to changes in the pattern of mortgage finance. The mortgage market has certainly changed a great deal since I was a first time buyer. In the 1960s and 1970s, access to finance depended on establishing a relationship with a particular mortgage provider, leading to the familiar 'mortgage queue'. Now of course most of the formal and informal quantitative controls have been relaxed, and the nature of the market has been dramatically altered by the entry of many new firms.

One implication of these changes is that consumers no longer need to wait till they move house to renegotiate the terms of their mortgage. The average turnover period for a mortgage has fallen from seven to four years over the past decade, and re-mortgaging now accounts for around a third of gross mortgage advances. Households have of course been keen to take advantage of the various discounts on offer in the market. But the rise in re-mortgaging has also been a response to the much greater variety of mortgage products on offer. For example, until a few years ago, all mortgages were floating rate. Such mortgages are attractive, of course, when interest rates are falling, as they have been recently; but they become less beguiling when rates have to rise! Fixed rate mortgages, which allow consumers to insure against this cashflow risk for some period, have become very popular in the UK, and now account for around a third of new mortgages sold.

The increased liquidity in the market, together with more flexible mortgage products, has also facilitated more frequent mortgage equity withdrawal, or 'MEW' for short. Research by the

Council of Mortgage Lenders suggests that around half of those remortgaging took the opportunity to withdraw equity. In the past, MEW has often been used to fund spending by households. MEW reached a peak of 8% of personal income at the height of the surge in consumer spending in the late-80s, but subsequently fell back sharply. In the past few years, it has risen back to around 4% of personal income, but – according to a recent MORI survey – at least part of this reflects substitution from other types of borrowing (such as personal loans and credit cards) rather than financing extra spending. The MPC looks closely at the data on mortgage equity withdrawal at our monthly meetings, but there is no automatic read-through from these estimates to demand prospects.

Greater availability of mortgage credit has also fuelled interest in the buy-to-let market, which has grown fivefold since 1998. The risks to financial stability of this activity are probably rather small – buy-to-let still only accounts for some 1½% of total UK residential mortgage balances outstanding. But given recent growth rates, the initiative announced by the Council of Mortgage Lenders to ensure that potential investors have the right information and advice before entering this market is timely.

**Low inflation**

My final medium-term issue relates to the effects of low inflation on the property market. The attractions of property as a hedge against inflation may seem to have diminished in a lower-inflation environment. But the benefits of property as an investment have never depended on high inflation alone. Some analysts have argued the case for property as an investment in an environment of low gilt and equity yields. And the introduction of FRS 17 has induced some pension funds to consider investing in more stable income streams, which might include rental income. I would at the same time however be cautious about how much faith one should put in analysts' estimates of the prospective earnings yield on property. These estimates may not fully reflect periods when property is vacant, or fully include the costs of refurbishing property. The impact of shortening lease lengths is also a key factor in the assessment of the attractiveness of property for investors. In the medium term at least, the returns from first class properties with first class covenants can never be that far apart from the cost of funds over the relevant period. In the past, borrowers in both residential and commercial property sectors might have been prepared to take on heavy initial debt service commitments in the knowledge that the real burden would fall over time as inflation eroded the nominal repayments. In periods of low expected inflation borrowers can no longer rely on this effect.

**The current macroeconomic environment**

Having set out some of the important longer-term trends, I now want to turn to look at the implications of developments in the property market for the Bank's goals of monetary and financial stability.

Let me take monetary stability first. As I have already said, the Bank seeks to ensure that inflation remains on target at 2½%, which is the best contribution we can make to the wider goals of sustainable growth and employment. Since the MPC was established, evidence on this has been reasonably encouraging, with annual GDP growth only falling below 2% in four quarters since 1997. Part of that weaker growth has of course occurred recently, as the world economy slowed sharply. The MPC has sought to keep inflation on track during this period by cutting interest rates to maintain domestic demand. The property market has played an important part in this delicate balancing act, but there are substantial differences between the role played by the residential market on the one hand, and that played by the commercial sector on the other.

**Developments in the residential market**

Activity in the residential market has grown rapidly in recent years. House prices have risen strongly, with demand for housing buoyant and supply constrained by low rates of house building. Though continuing divergence between the main measures complicates the assessment, both the Halifax and Nationwide measures suggest that annual house price inflation is currently running at levels in the mid-teens. That broad picture is corroborated by the balance measure prepared by the Royal Institution of Chartered Surveyors, which points to continuing strength in house price inflation over the next few months.

The rise in house prices has been accompanied by strong growth in borrowing. Mortgage lending has risen by over 8 per cent per annum on average since 1999; and the average mortgage loan is now some £70,000, substantially above the previous peak in the late 1980s even after adjusting for inflation. Part of this borrowing consists of mortgage equity withdrawal, which has risen sharply in recent quarters as I noted earlier. But the economic implications of increased borrowing depend, not just on the absolute size of the rise in borrowing, but on households' ability to manage and service that debt. Despite the sharp rise in borrowing, lower interest rates mean that interest payments currently account for some 8% of households' post-tax income, well below the 15% peak recorded in 1990. Broader measures of debt servicing costs, which include an element of principal repayment, are also well below the level seen in the early 1990s.

**Developments in the commercial property market**

This strength of the residential market contrasts with conditions in the commercial sector. Lending to commercial property companies has also been growing rapidly, at more than 20% at an annual rate for the past year and a half. But, according to the Investment Property Databank, rental value growth has been slowing since autumn 2000, and capital values have been falling in absolute terms since autumn 2001. This partly reflects supply conditions – availability has been boosted by secondary space as well as new developments – but demand for occupational space has also weakened.

The differences between residential and commercial property mirror the current imbalances in the UK economy, on which the MPC has had a good deal to say in its minutes. The buoyancy of the housing market is closely associated with the strength of domestic demand; while the relative weakness of the commercial market mirrors the retrenchment in the scale of the operations of multinational companies in the UK, as well as the effects of the slowdown in global demand on internationally-exposed UK companies. As with all imbalances, this situation will eventually have to be resolved. But this need not necessarily involve a sharp correction in residential property prices. The MPC's central projection for activity and inflation has been consistent with a more gradual cooling in residential demand, and some recovery in the commercial sector on the back of an improvement in the international economic environment.

**The property market and the MPC**

What does all this mean for monetary policy? There are some who believe that the MPC should act now to contain what they perceive to be a dangerous 'bubble' in house prices. I am not convinced by this view, for two reasons.

First, while residential house price inflation has caused some concern, and can clearly not be sustained forever at current rates, the evidence for a bubble is not conclusive. By their very nature, bubbles are hard for policy makers to identify, particularly at the time. I do take some comfort however from the fact that the ratio of house prices to households' post-tax earnings is still well below the levels seen in the late 1980s. Of course, multiples are rather higher in London and the South East – but it is the MPC's job to set interest rates for the country as a whole, not for particular regions or sectors.

The second point is that our mandate is to target RPIX inflation, not house prices. House prices are by no means irrelevant to aggregate inflation – there are many important links through consumers' spending and saving decisions, as I have already discussed, and the MPC studies the latest evidence on this at its monthly meetings. But inflation is affected by a whole raft of other factors as well, and these also need to be taken into account in our overall policy judgment. Even if the property market gets out of line, monetary policy adjustment is appropriate only to the extent that property developments risk the inflation target not being met.

On balance, my view is that the current state of the housing market does not, taken on its own, raise undue concerns for the inflation outlook. But we need to – and will – stay alert to developments in the data. And both we, and the markets, need to recognise that the build up in debt creates heightened downside risks. Though debt service burdens do not appear to be excessive at current interest rates, higher borrowing makes the household sector more vulnerable to unexpected falls in income or increases in interest rates. Perhaps financial innovation and greater macroeconomic stability have raised the sustainable level of debt – but we do not know this for sure, and it is the job of central bankers to remain cautious.

## The property market and financial stability

Let me finally say a word about financial stability, where our principal concern is that lenders and borrowers should not become over-stretched. The larger the total debt burden, of course the more likely it is that an adverse change in macroeconomic conditions might trigger default by borrowers, and losses for the UK financial system. But there is little sign as yet of a major increase in property-related defaults by borrowers or losses for banks. Nor do we think that such an increase is likely if the current slowdown in activity proves to be short-lived, which was the MPC's central projection in its most recent *Inflation Report*. In the medium term, of course, what matters is that both lenders and borrowers should have realistic expectations and sufficient margins to cope with unexpectedly adverse outturns. The smaller scale of speculative development in the commercial sector should reduce the chances of another severe property cycle, especially if claims by lenders of improved credit practices prove to be substantiated.

## Conclusions

Hard lessons were learned after the problems in the property market in the early 1990s. There is no evidence that these lessons have been forgotten. But central bankers are paid to worry; and we always look for hard facts rather than simple assertions that 'things will be different this time'. New financing techniques give rise to new risks – for borrowers, lenders and policy makers. And that is why the Bank will continue to monitor and assess property market developments closely, and seek to identify potential problems. I hope I have said enough this evening to illustrate why such analysis is directly linked to our core objectives as a central bank.

ENDS