April 2016
Safeguarding growth and stability in real estate and beyond
Safeguarding growth and stability in real estate and beyond
Key Takeaways

- Sustainable growth in the real estate industry and overall economy can be better achieved through enhanced market transparency and greater levels of confidence and trust enabled by the profession.

- Expansionary fiscal policy can play a larger role in driving growth in a world of secular stagnation. The confluence of low interest rates and low commodity prices are supportive for increased public spending, particularly on infrastructure investments such as energy efficiency and renewable technologies.

- Higher interest rates may not be the appropriate monetary response if the amount required to manage asset prices in one sector has a disproportionately negative influence on the rest of the economy.

- A more targeted approach that utilises counter-cyclical regulations and supervision is more likely to address excesses as they materialise whilst promoting a less pro-cyclical industry response in the event of a downturn.

- The effectiveness of macroprudential regulations stems from its calibration with different phases of the cycle. Policies that “lean against the wind” can more effectively reduce the amplitude of market volatility, allaying the fear- and greed-driven impetus behind many asset price bubbles.

Overview

The depth and breadth of the Global Financial Crisis has confounded policymakers for nearly a decade. Although real estate and property factor prominently in discussions related to financial stability and the management of economic cycles, little consensus has emerged as to how better to detect, prevent or treat the fallout from irrational market exuberance.

Undoubtedly, the economic, social and political dimensions that the industry straddles add to the policy dilemma. Monetary and fiscal levers surely have a role, but so does macroprudential regulation and supervision. The relative nascent of the latter adds to what are already uncertain times, but a cohesive strategy that draws on the experience and knowledge of stakeholders from across the market spectrum should ultimately benefit both macroeconomic and financial stability.

In a sustained low growth, low inflation environment, central banks in the industrialised world have adopted extraordinarily accommodative monetary policy positions with zero interest rates, quantitative easing, and negative interest rates now becoming the norm. Despite substantial fiscal stimulus in the years immediately following the Global Financial Crisis (GFC), the recovery has been anaemic and fallen significantly short of expectations.

In January 2014, the IMF estimated that world GDP would be 3.9% in 2015, led by a rebound in emerging market and developing economies (EMs). What materialised instead was the flat-lining of economic growth at 3.1%, with growth in EMs declining for a fifth consecutive year.

In its most recent world economic outlook entitled “Subdued Demand, Diminished Prospects,” the IMF has yet again downgraded its projections with global GDP reaching its long-term average only in 2017.

Persistently sluggish aggregate demand coupled with the lack of traction gained through highly stimulative credit supply has left policymakers puzzled. Central banks in industrialised countries are low on ammunition and reliant on hitherto untested, unconventional policy tools. After years of pump priming, governments too have felt the pressure to rein in spending, either through external mandates (e.g. Greece) or internally imposed fiscal rules (e.g. UK).

Nine years into the so-called economic “recovery” since the GFC, is the “new normal” one of structurally lower growth and productivity? Alternatively, are indicators such as resilient domestic demand, lower unemployment and gradually rising core inflation in countries such as the US and UK signs of a return to earlier growth trends?
Fiscal Impetus

According to the theory of secular stagnation, first posited in response to the Great Depression and more recently refreshed by Larry Summers, the weakness of the global recovery since 2008 is due to an imbalance between savings and investment. Excessive saving driven by factors such as an uncertain labour market and ageing population have lowered demand, which reduces growth, inflation and, in turn, real interest rates.

Enhanced financial regulations, slower growth in the labour force, and rapid technological obsolescence have meanwhile worked to reduce overall levels of investment. This mismatch channelled the flow of savings into existing assets such as housing, and together with lower real rates encouraged a debt binge that fuelled a bubble. When inflation is low and interest rates are at or near the zero lower bound, as is currently the case in many advanced economies, monetary policy loses its effectiveness in balancing saving and investment to achieve full employment. Instead, the growth that materialises is heavily reliant on the potentially destabilising wealth effects generated from asset and credit markets.

Expansionary fiscal policy can play a larger role in driving growth in a world of secular stagnation. The confluence of low interest rates and low commodity prices are supportive for increased public spending, particularly on infrastructure such as high-speed rail, open-access fibre-optic broadband, energy efficiency and renewable energy technologies.

Admittedly, a competitive bidding process that encourages the underestimation of project costs and delivery times has frustrated fiscal budgets and the commitment of politicians bound to elections. International standards within the real estate profession can help in this regard.

Social and economic progress does not thrive on creaky infrastructure, however, and the multiplier effects generated through such longer term public investment would stimulate growth and enable the inflation needed to lower real capital costs to attract business investment. Moreover, reforms in business taxation and regulation can better promote business confidence, whilst increased labour compensation through progressive wage schemes can stimulate demand by enabling consumption in those with the highest propensity to consume. The additional fiscal deficits accrued from such expansionary policies would be financed by long-term bonds at relatively low rates. Globalisation has increased the importance of international policy coordination as well. Ultra-loose monetary policy can trigger a downward spiral of competitive currency devaluations and protectionism, which would be highly counterproductive in lifting global aggregate demand. For example, the Smoot-Hawley Tariff Act of 1930 raised US tariffs on over 20,000 imported goods to record levels prompting retaliatory tariffs by its trading partners which likely extended the Great Depression.

More recently, global trade volumes have increased more slowly relative to global output in each of the past five years. To neutralise what has become an over-reliance on easy money and its toxic side-effects, fiscal stimulus in areas such as infrastructure investment can raise domestic demand, restore confidence and accelerate the economic recovery across countries and regions. Until growth and inflation return to a more stable trajectory, an approach focused on monetary normalisation and fiscal austerity could reinforce secular stagnation and contribute to the erosion of living standards.
Investment in commercial real estate (CRE) has grown exponentially over the past thirty years, transforming the industry into an institutional asset class that will be recognised as part of a stand-alone sector within the MSCI and Standard & Poor’s Global Industry Classification Standard (GICS) in August 2016. According to the Conference Board, institutional fund managers now allocate about 10% of their portfolio to real estate investments compared to just 2% in 1980. Sovereign wealth funds such as Norway’s $850 billion Government Pension Fund have raised asset allocation targets into real estate from zero to 5% in just five years; the Abu Dhabi and Qatar Investment Authorities currently have a combined $70 billion exposure. The acceleration of institutional capital to the sector is formidable, considering that institutional investors control about $70 trillion of assets under management globally, according to data from the Boston Consulting Group. Moreover, easier access to investment vehicles, such as real estate investment trusts (REITs), and greater market transparency through enhanced industry regulation and supervision have facilitated capital flows into CRE. With its low correlation to other asset classes, real estate can provide important portfolio diversification benefits whilst serving as a hedge against inflation.

If CRE has and is to play an increasingly prominent role in financial market activity, then it is equally important to understand its relative past and how that might inform decision-making for a more stable and secure future. Unlike other asset classes such as equities, bonds or even commodities, real estate has both a functional and financial dimension that complicates its understanding as a cyclical investment. Long-term rental contracts do not align well with the short-term planning horizon of many tenants, and capital valuations of properties depend on large variations in investor discount and borrowing rates. Whereas debt and equity investment was once sourced locally, globalisation has expanded the investor base thereby accentuating volatile swings in capital availability and occupier demand. Geopolitical and socioeconomic risks, such as the upcoming Brexit referendum in the UK, have the potential to shift the market prioritisation and business planning of multinationals in unexpected ways. Sudden market illiquidity or value cyclicality could produce sizeable asset price distortions that, if left unattended, could result in a market crash.

Surpassed only by the Great Depression of the 1930s, the GFC was associated with steep declines in economic output, higher unemployment and lost paper wealth. The total economic cost in the US range in estimates from $12 billion to over $22 trillion, although the cumulative damage will probably never be known. If a 20% average peak-to-trough price fall is used as conservative estimate for a bubble burst, then the nearly $5 trillion US CRE market could trigger a sizeable economic downturn with the potential for financial contagion elsewhere. Given that real estate is a fixed asset, the frequency and chronology of CRE market bubbles will inevitably vary across countries. Wherever the next crash may fall, reducing the risk of damage to the financial system and the long-lasting destabilisation caused requires a more developed understanding of asset price dynamics.

The composition of equity and debt flows into CRE markets is a key driver of cycles. During the ten year period from 2001 to 2010, equity investment into the European real estate sector remained fairly stable whereas debt flows exhibited noticeable volatility. In the run-up to the GFC, the average equity to debt ratio fell from 45% to 28% before returning to 50% post-crisis, according to data from the CBRE. Pro-cyclical lending behaviour accentuates the boom and bust phases through distorted valuations of cash flow and perceived risk of loss.

Market euphoria drives competition amongst lenders to misprice risk as risk exposure and value at risk intensifies. These negative feedback loops become self-fulfilling, compressing loan margins unsustainably while accompanied by inadequate capital reserve accumulation by lenders to offset potential losses. Lending volumes rise disproportionately to underlying property valuations until a tipping point is reached. By current definition, systemically important financial institutions (SIFIs) then require a rapid infusion of funding through a government bailout. The moral hazard of this model is that the benefits of the cyclical upswing are privatised whilst the subsequent costs of a crash are socialised.
Safeguarding growth and stability in real estate and beyond

Monetary and Macroprudential Measures

With growth prospects weak and uncertain, the role of monetary policy in balancing financial stability and price stability has come to the forefront. One of the key risks is that low interest rates, when sustained, can encourage excessive leverage and risk taking, thereby promoting the formation of bubbles. While this may be true, higher rates alone may not be the appropriate response if the amount required to manage asset prices in one sector has a disproportionately negative influence on the rest of the economy. A more targeted approach that utilises counter-cyclical regulations and supervision is more likely to address excesses as they materialise whilst promoting a less pro-cyclical industry response in the event of a downturn. Strengthening the resilience of the financial system through such a macroprudential framework thereby informs monetary policy, enhancing its overall effectiveness.

Financial stability can be enhanced by decoupling the lending and regulatory cycles from the real estate market cycle. A “through the cycle” approach to macroprudential regulation and supervision should help to balance the pro-cyclical tendencies of both lender activities and regulatory oversight, thereby reducing the range of peak to trough outcomes. Tools that can increase the resilience of the financial system to adverse shocks include requirements for SIFIs and other financial institutions to hold sufficient liquidity buffers and levels of loss-absorbing capital to offset unexpected losses, particularly in the case of a bank run. In the event of the latter, an effective resolution regime needs to be in place to prevent contagion to other market participants. Meanwhile, minimum margin and central clearing requirements for derivative transactions could serve to better address the linkages between financial firms.

The stress tests and countercyclical capital requirements introduced in Basel III can contribute to this added resilience by targeting risks as they emerge. Finally, a regulatory framework that provides sufficient oversight of the shadow banking system and covers a more comprehensive array of systemically important institutions and activities can also help to prevent risks from migrating to the periphery.

Given the relative size of the real estate market and the diversity of its stakeholders, promoting greater stability and countercyclical mechanisms that reduce excessive volatility and risk are of paramount importance. Historically, the causes of booms and busts within CRE have varied based on factors such as comparative economic and market conditions, the perception of risk adjusted returns, and investor myopia. Rather than assessing the likelihood of a market collapse, the effectiveness of macroprudential regulations stems from its calibration with different phases of the cycle.

In a report entitled “A Vision for Real Estate Finance in the UK,” the cross-industry Real Estate Finance Group and Investment Property Forum have outlined a framework for reducing the risk of damage to the financial system from the next commercial real estate market crash. While its assessment is specific to the UK, the insights and recommendations provided have much broader applications. For example, the lack of data, transparency and consistency in real estate markets has challenged the ability of regulators to regulate effectively. A centralised database containing granular and timely information on loan characteristics could inform discussions on market performance and risk, as could access to the expertise and analyses from a range of market participants.

To promote stability and resilience, appropriate incentives need to be in place for both individuals and institutions. This includes the adoption of long-term value measures that are insensitive to the investment cycle as well as greater differentiation of risk in regulatory capital requirements. Moreover, the regulator can encourage a better balance of CRE debt supply which should lead to greater diversity in lender response to market signals. Rather than rely on abrupt interventions such as outright bans or caps, a regulatory structure based on automatic and incremental counter-cyclical measures can embed consistency across the cycle.
Looking Ahead

Strengthening the resilience of the financial system is critical to reducing financial instability and the potential fallout, but it will not eliminate asset market bubbles altogether. Human creativity and financial innovation may always be a step ahead of any regulator, so the goal should be to minimise risk through evidence-based analytics tempered with reasoned judgement.

While attempting to predict the trajectory of an asset bubble may be futile given the myriad of market dynamics at work, it can be instructive to identify economic and financial variables capable of serving as leading indicators. The World Economic Forum has recently developed an early warning system that links inflation rates, bond yields, consumer confidence, employment, and net operating income to the risk of a CRE market crash. Through the usage of value index creation, peak tagging and risk model training, the prototype predicts a greater than 70% probability for a downturn in six major US CRE markets over the coming year. While the methodology has yet to be refined to consider spillover effects at the national and global levels, it is a useful starting point for mitigating risk when combined with traditional real estate portfolio analysis.

The devastation caused by the global financial crisis and its prolonged duration call for a more coordinated approach to policymaking. If an ounce of prevention is worth more than a pound of cure, then a more cohesive and coherent framework of international regulations and standards can provide the foundation necessary for financial stability.

While this is apparent for the real estate sector, where boom-bust cycles have invariably been followed by recessions, it applies to a wider array of asset classes as well – stocks, bonds, and more recently, commodities. Policies that lean against the wind can more effectively reduce the amplitude of market volatility, allaying the fear- and greed-driven impetus behind many asset price bubbles.

In a highly interconnected global economy driven by rapid technological change, the current sense of anxiety is palpable. Geography no longer binds the mobility of capital or labour, each in pursuit of higher returns. Such fluidity of resources creates extraordinary opportunities as well as risks. Ultimately, sustainable growth in the real estate industry and overall economy can be better achieved through enhanced market transparency and greater levels of confidence and trust enabled by the profession.
Confidence through professional standards

RICS promotes and enforces the highest professional qualifications and standards in the development and management of land, real estate, construction and infrastructure. Our name promises the consistent delivery of standards – bringing confidence to the markets we serve.

We accredit 118,000 professionals and any individual or firm registered with RICS is subject to our quality assurance. Their expertise covers property, asset valuation and real estate management; the costing and leadership of construction projects; the development of infrastructure; and the management of natural resources, such as mining, farms and woodland. From environmental assessments and building controls to negotiating land rights in an emerging economy; if our members are involved the same professional standards and ethics apply.

We believe that standards underpin effective markets. With up to seventy per cent of the world’s wealth bound up in land and real estate, our sector is vital to economic development, helping to support stable, sustainable investment and growth around the globe.

With offices covering the major political and financial centres of the world, our market presence means we are ideally placed to influence policy and embed professional standards. We work at a cross-governmental level, delivering international standards that will support a safe and vibrant marketplace in land, real estate, construction and infrastructure, for the benefit of all.

We are proud of our reputation and we guard it fiercely, so clients who work with an RICS professional can have confidence in the quality and ethics of the services they receive.

United Kingdom RICS HQ
Parliament Square, London SW1P 3AD United Kingdom
+44 (0)20 7334 3811
contactrics@rics.org

Media enquiries
pressoffice@rics.org

Ireland
38 Merrion Square, Dublin 2, Ireland
+353 1 644 5500
+353 1 661 1797
ricsireland@RICS.org

Europe (excluding UK and Ireland)
Rue Ducale 67,
1000 Brussels, Belgium
+32 2 733 10 19
+32 2 742 97 48
ricseurope@RICS.org

Middle East
Office D14, Block 3, Knowledge Village, Dubai, United Arab Emirates
+971 4 446 2808
ricsmiddleeast@RICS.org

Africa
PO Box 3400, Witkoppen 2068, South Africa
+27 11 467 2857
+27 86 514 0655
ricsafrica@RICS.org

East Asia
3707 Hopewell Centre, 183 Queen’s Road East
Wanchai, Hong Kong
+852 2537 7117
+852 2537 2756
ricsasia@RICS.org

ASEAN
06-22 International Plaza,
10 Anson Road,
Singapore 079903
+65 6635 4242
+65 6635 4244
ricssingapore@RICS.org

Americas
One Grand Central Place,
60 East 42nd Street, Suite #542,
New York 10165 – 2811, USA
+1 212 847 7400
+1 212 847 7401
ricsamericas@RICS.org

China (Shanghai)
Room 2006, Garden Square,
968 Beijing Road West,
Shanghai, China
+86 21 5243 3090
+86 21 5243 3091
ricschina@RICS.org

China (Beijing)
Room 2507–2508B, Jing Guang Centre,
No.1 Hu Jia Lou Road, Chaoyang District
Beijing 100020, China
+86 10 6597 8586
+86 10 6581 0021
ricschina@RICS.org

South America
Rua Maranhão, 584 – cj 104,
São Paulo – SP, Brasil
+55 11 2925 0068
ricsbrasil@RICS.org

Japan
Level 14 Hibiya Central Building,
1–2–9 Nishi Shimbashi Minato-Ku,
Tokyo 105-0003, Japan
+81 3 5532 8813
+81 3 5532 8814
ricsjapan@RICS.org