
SPECIAL COMMENTARY

The Reality of Realty

Real estate market can be divided into two main categories. The first is land sales, where a property is purchased and sold after being filled and sub-divided. The second is where property is purchased and houses or apartments are constructed and sold. Within this category, there is also a concept where apartments and houses are built and sold but the developer retains the common areas and continues to maintain it. Yet another concept is where the building is rented out and the income is derived mainly from rentals.

Property development and housing construction have become very lucrative money spinners and are perceived as being a sure way to make quick profits. Further, lending against real estate is fast being considered almost risk free. This euphoria has led many a financial institution to venture into and lend against real estate, without being fully conscious of the risks and the impact of over-lending towards this sector, especially in the light of these institutions accepting public deposits and using such deposits to venture into real estate business.

Sri Lanka in recent years has seen a surge in construction and sale of apartments, housing schemes, and shopping and office complexes. The property market began to surge with companies buying large tracts of land, especially rubber estates, and subsequently developing, sub-dividing and selling these properties. With the prospects that arose from the cease-fire and the favourable investment climate that followed, the housing construction sector boomed. Over the past decade real estate prices have sky rocketed reaching dizzying heights, setting the stage for a classic real-estate bubble. The real estate bubble implies that real estate prices are at a high level despite worsening fundamentals, and feed on investors' expectations that the prices of property will continue to rise even though it is already overvalued.

At this juncture it would be wise to step back and take a look at the experiences of South East Asia and the 1997-1998 crises which is largely blamed on lending excessively for real estate. The problem began with financial intermediaries whose liabilities were perceived as having an implicit government guarantee, but were essentially unregulated and therefore subject to severe moral hazard problems. The excessive risky lending of these institutions created inflation – not of goods but of asset prices.

Real estate is among the most highly leveraged sectors of an economy, which makes it more likely than others to precipitate a financial crisis. Compounding the problem is the tendency of real estate to overshoot during boom periods, producing a real estate bubble. Once pricked, it results in large price declines. This happened in some Asian countries in the 1997-1998. Declining real estate values led to loan losses which reduced liquidity in the affected economies. On the spending side, consumption was impacted due to wealth effects.

A large body of literature has examined the role of the banking/financing sector in propagating business cycles. These studies demonstrated that the workings of the financial sector can amplify the magnitude of the business cycle as bank credit exposure moves procyclically. In the aftermath of the Asian financial crisis, many researchers have examined the role played by the real estate sector in the crisis, and have argued for reforms in the regulation of the real estate markets and the treatment of real estate loans by financial institutions in order to prevent the recurrence of the kind of asset bubbles that contributed to the financial crisis. Commentators have noted that real estate markets are vulnerable to waves of optimism and herd behaviour that result in bubbles.

The role of real estate in the 1997-1998 Asian financial crises varied from country to country. The origins of the Asian real estate bubble can be traced to the surge in capital inflows into East Asia in the early 1990s, when emerging Asian economies were experiencing strong economic growth. As foreign capital flowed into Asia, speculation in the real estate market, driven by cheap financing, was rampant. In many countries, loan quantum and credit facilities of up to 90% of the collateral value were common for investments in real estate properties. This flood of liquidity led to a sharp price appreciation in the asset markets, inflated collateral value and prompted further credit expansion as asset prices climbed.

Asia's real estate bubble started to deflate in early 1996, as U.S. interest rates started to rise and borrowing became expensive. The commercial real estate markets fell sharply across Asian cities during this period. Property prices plunged by an average of 40%. Similar declines were recorded for the residential real estate property markets as well.

The problems as well as solutions to the crisis have been quite different among affected countries.

In four economies -- Korea, Taiwan, Hong Kong and Shanghai -- real estate didn't cause much of a problem because it didn't form a bubble that later burst. In Korea, for instance, banks are prohibited from making loans for real estate development. The real estate sector had also experienced a downturn just prior to the crisis, so it didn't enter the financial crisis with a fully-inflated housing bubble. The country's 1997-1998 crises were caused more by its unique system of corporate lending to the country's large conglomerates.

In Taiwan, during this period, land prices rose and then stabilized. Property prices didn't crash, unlike in other Asian economies. This was partly due to the government successfully regulating the financial system. In Hong Kong, land prices fell during the financial crisis, but its lending rules required high equity funding. With leverage low, a credit bubble didn't form or burst. The decline in Hong Kong's real estate prices had relatively little impact on the rest of the economy. In the case of Shanghai, the office market became overbuilt but Shanghai's strong economy prevented a price collapse.

In three Asian economies, however, real estate prices did crash, exacerbating the financial crisis. Japan saw rising property prices from 1984 to 1991, partly as a result of a strong economy and scarcity of land. Poor commercial and residential real estate underwriting played a role in the price downturn. So did the practice of permitting the market value of real estate to be included in bank reserves. High leverage meant that a small downturn in value was enough to expose inadequate bank reserves. It even produced negative equity at some banks.

In Indonesia, the collapse in real estate was compounded by the currency collapse. Since many of the real estate sales were made in US dollars, the value of real estate fell with the collapse of the rupiah. At the same time, the currency fall meant that US dollar denominated debt became more expensive and harder for borrowers to service.

In Thailand, the collapse of its currency compounded the real estate decline. Foreign investors (especially Japanese) fled the country, which put severe pressure on the currency. Thailand was able to recover more quickly than other countries by seizing and selling distressed assets. While these sales often resulted in large losses to the government, they quickly brought liquidity back to the system. Thailand returned to a path of solid growth by 1999, ahead of other affected countries.

In conclusion, Sri Lanka too has seen the property market being driven by the prospects of the cease-fire and the economic dividends that followed; flushed liquidity, low interest rates and higher inward foreign remittances coupled with favorable macro-economic conditions. However, these property market drivers are dissipating and this may trigger a reversal of trends in the fortunes of real estate. Weak regulations and the lack of information regarding property markets in Sri Lanka, compared to other East Asian economies, are likely to further aggravate this situation. Hence, real estate companies, financial institutions, investors and regulators alike would do well to take a lesson from the experience of our Asian counterparts.

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