DRIVERS OF THE GLOBAL REAL ESTATE FINANCIAL MARKETS

Thought Pieces of the Real Estate & Urban Development Industry Agenda Council, 2010-2011
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The world no longer views real estate as a narrowly-defined local industry after the 2007 global financial crisis triggered by the sub-prime mortgage market meltdown in the US. Rather, the real estate industry now plays a pivotal role in the global financial market and the world’s economic health.

In response to this emerging trend, leading experts of the World Economic Forum’s Real Estate & Urban Development Industry Agenda Council have focused their effort on positioning the real estate industry from a more global and multistakeholder vantage point that explores multidisciplinary solutions and multilateral collaboration.

As a result, the Council recognized the need to better understand the drivers of the global real estate financial markets as the main discussion topic for the Council term 2010-2011. Through various virtual meetings and at the annual Summit on the Global Agenda, the Council identified the following three key drivers that are critical to continuously shape the global real estate financial markets and the broader economy in the next 15 years and beyond. The Council has proposed a set of questions under each of these key drivers to facilitate further thinking and dialogue:

**Driver 1: Transparent, Reliable and Consistent Data for Real Estate Investments**

- **Dimension 1: What data?**
  What market fundamentals and real estate financial instruments data are needed? Are conventional real estate data adequate for investment analysis and decisions? How can data capture the importance of economic structures?

- **Dimension 2: Trustworthiness and reliability of data**
  How does one ensure data integrity and availability? Who should regulate and ensure accountability?

- **Dimension 3: Appropriate and valid analytical tools and methods**
  What are the appropriate methods and tools? How does one reduce the over-reliance on third-party investment analysis of the data?

**Driver 2: Policies, Governance and Standards**

- **Dimension 1: National and super-national policies for a global crisis**
  What is the right balance between national and super-national regulations of real estate investment capital flows? What is the subsequent risk of capital arbitrage?

- **Dimension 2: Mismatch between short-term policy response and long-term investment objective**
  How does one ensure policy predictability? How does one avoid short-term policy swings, which will likely attract short-term investments that destabilize the real estate market?

- **Dimension 3: Government intervention and sovereign risk**
  How does one properly analyse the “sovereign risk” for countries where the government is a key real estate player (or a key player in its financing)? What is the appropriate role and extent for government intervention and “de-risking” (e.g. help move distressed assets and increase market liquidity)? How does one educate regulators (and policy-makers) to avoid rushing to create policies that disable the market and create future risks?

- **Dimension 4: Impact of demographic trends and social policies**
  What is the impact of demographic changes on real estate development and investments? How do social policies, such as homeownership incentives, impact real estate investments?

- **Dimension 5: Sustainable development**
  What is sustainability development’s impact on investment risk exposures and decisions? How does one link the sustainability dimension to the financial market?
Driver 3: Sources of Capital and Structures of Investment

- **Dimension 1: Coping with lower capital availability and return**
  How can the real estate industry cope with lower availability of capital (especially in debt), lower return on investments and more regulations for the market? Are risk sharing and safe but lower return instruments like Pfandbrief the answer?

- **Dimension 2: Finding the right balance in new sources of capital and structures of investments**
  What is the appropriate balance between different types of capital sources and investment structures, such as equity and debt, short-term and long-term, public and private, and regulated and unregulated instruments and markets?

- **Dimension 3: Developing effective risk management**
  How can the real estate (investment) industry develop appropriate risk management strategies where risk is not the exclusively dominant criterion for investment decisions (i.e. avoid the risk of risk management)?

- **Dimension 4: Scarcity of capital for the riskier market segments**
  How to finance properties that are middle to low quality, in less transparent markets, and/or in developing markets as a result of capital’s “flight to quality”?

After extensive discussions throughout the year on these topics, numerous Council Members have taken the effort to author the following thought pieces to encapsulate their ideas around some of these issues. The drafts of these thought pieces were presented and discussed at the World Economic Forum Annual Meeting 2011 in Davos-Klosters.

The Forum is very grateful for the contribution of the Council, especially the Council Members who took on the extra task to author the thought pieces in this volume. As the global real estate financial markets are still in fragile condition in their slow recovery, the insights and advice from the Council will continue to shape the discourse of how to improve and strengthen such markets. The Forum looks forward to continuing engaging the Council this term on these important topics.

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The Implications of the Financial Crisis on the System of Housing Finance in Developing Countries
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Introduction
Housing is a key contributor to social stability and economic development in the developing world. Therefore, the availability of properly functioning housing finance markets that increase the affordability and supply of housing to individuals is a key policy issue for many policy-makers. Yet, many developing economies have failed to establish efficient housing finance markets, despite recognizing their importance.

The global financial crisis, which is mainly blamed on the US housing finance market, is threatening to further delay the establishment of housing finance markets in the developing world as policy-makers grapple with lessons from the crisis to avoid a repetition in their own markets, once established. However, it is important to recognize that, despite its failings, the US housing finance market is one of the most successful and efficient markets in the world and that many lessons can be drawn from its successes and failures.

The objective of this piece is to highlight the importance of housing finance to the social stability and economic development of the developing world; the key elements required to set up a functioning housing finance market; and the lessons learned from the US housing crisis and their implications on regulations in developing economies.

Importance of Housing Finance to Social Stability and Economic Development

It is important to set the foundation of the housing finance sector by providing the market with the appropriate means and tools for accurately calculating and efficiently managing the risks associated with originating individual loans. Housing finance represents an important contributor to social stability. First, it facilitates the largest investment that most households ever make. In fact, according to the IFC, personal housing accounts for anywhere between 75% and 90% of household wealth in developing countries. It also represents 15-40% of monthly household expenditure. In addition, housing contributes greatly to family self-sufficiency and community development, both of which are critical to social stability in society.

Housing finance is also a main contributor to macroeconomic development. According to the IFC, investment in housing accounts for 15-30% of aggregate investments worldwide. In addition, housing finance supports the development of the housing sector and its related industries, which account for 9% of all jobs in the world.

Policy Framework for Setting Up a Housing Finance Market

Given the importance of the housing finance sector to the economy and social stability of developing countries, policy-makers should accelerate the deployment of the right policy framework to spur the growth and ensure the long-term sustainability of the sector.

Such a framework is based on two basic concepts: First, it is important to set the foundation of the sector by providing the market with the appropriate means and tools for accurately calculating and efficiently managing the risks associated with originating individual loans. Such means and tools include the ability to register deeds and liens, the ability to enforce mortgage liens, the ability to efficiently foreclose in case of default, the establishment of proper credit reporting agencies, the availability of professional standards for property appraisal, and the availability of accurate local market data on the asset class.

These tools allow lenders to better identify credit worthiness, more efficiently value collateral, lower the cost of processing in case of default and enhance the overall level of decision-making, which leads to lower costs of lending and hence higher affordability and market coverage.

In addition to setting up the market foundation, policy-makers will need to address the challenge of access to long-term funding. In less-developed mortgage markets, lenders largely depend on short-term deposits as their main source of funding and might not have access to long-term funds. This prohibits them from making long-term mortgages to home buyers as it would expose their balance sheets to an asset-liability mismatch.

To spur market development, some governments have created (or sponsored) housing finance agencies (such as Fannie Mae and Freddie Mac in the United States) that allow lenders to avail longer-term mortgages via several methods, including the direct provision of long-term funds by the agency to lenders, the purchase of lender-originated mortgages by the agency or the provision of loan guarantees (explicit and implicit) on loans issued by lenders.

Through direct sponsorship or outright ownership of such housing finance agencies, the government lowers the risk of funding and increases the availability of liquidity for market participants, which results in decreasing the cost of finance and increasing periods of lending to homeowners, both of which enhance affordability and facilitate home ownership. In due course, the housing finance agency starts accessing secondary markets for
liquidity by directly issuing debt and other instruments to other investors, which leads to deepening the market and lowering the cost of capital for all participants.

Lessons from the Financial Crisis

Given that the global financial crisis started in the US housing finance market and the US model followed exactly the prescription highlighted above, what are the lessons that policy-makers can discern from the US experience as they set up their own housing finance markets? While many reasons are cited for the US financial crisis, the two issues at its core were that loans were made to low-credit candidates on the basis of the strength of their collateral alone, which was not ideal but acceptable as long as housing prices continued to rise (they did not); and that these loans were grouped and resold with the assumption that grouping them sufficiently reduces the risks associated with the pool and elevates them to investment-grade quality.

Unfortunately, we now know that grouping bad loans improves the overall risk of the pool from bad to better, but does not necessarily make them investment-grade material. As the markets figured out that it had badly mispriced the risks associated with these loan pools, the secondary market for trading them completely dried up and those institutions holding them had to deal with the aftermath of holding assets that were significantly underperforming and utterly illiquid. The rest, of course, is history.

While policy-makers can draw many lessons from this experience, two are paramount. First, avoid making bad loans; second, if a government wants to make bad loans for political reasons, it needs to establish an explicit socio-economic policy to manage the associated risks. In addressing the first lesson, policy-makers need to establish strict lending standards to ensure that loans are extended in a sustainable manner. These standards need to be in line with the social and economic policies that their governments have elected to pursue. Such lending standards can be established through licensing standards for mortgage initiators and/or through setting minimum standards for the mortgages that its housing finance agency would buy or guarantee.

As for the second lesson, if a government chooses to subsidize the homeownership of a certain segment of its populations as part of its social policies, then such a government should explicitly, and not implicitly, do so by establishing special programmes and vehicles to achieve such goals (it can also do so by guaranteeing potentially non-performing loans or by buying them outright).

The explicit policy allows the market to more accurately price such loans and the risk associated with them, and allows the government to more accurately and transparently offset the cost of such a subsidy against the benefit of economic development and social stability. Not being specific about the government’s social policies with regards to housing, and the extent of its guarantees, can lead the markets to make more and more aggressive assumptions about the depth of the government’s guarantee, leading to market inefficiencies and, ultimately, leaving the door open for a future crisis.

Policy-makers need to set sustainable lending standards that meet the social and economic development needs of their countries, and be explicit about housing policies for the less fortunate segments of their population.

Conclusion

Despite the fact that the global financial crisis stemmed from the US housing finance market, the socio-economic benefits of setting up such a market in developing countries are tremendous. Policy-makers in developing countries are advised to introduce policies that guarantee the development and long-term viability of the market by focusing on lowering the cost of lending and spurring the development of the market by creating a mortgage finance agency that enhances the markets’ access to capital.

While doing so, policy-makers need to set sustainable lending standards that meet the social and economic development needs of their countries, and be explicit about housing policies for the less fortunate segments of their population for the market to function properly in the long term.
Ageing, Quality of Life, and the Housing Market in Developing Economies
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The ageing population phenomenon has become an important social and economic issue in many urban
cities in Asia and other developing economies. Rapid
economic progress and urbanization have put severe stress on social networks as well as the support infrastructure for the elderly.

In a recent report by the (Singapore) Straits Times on 28 September 2010, suicide rates of the 70-74 age group in Beijing surged above 33 per 100,000 between 2002 and 2008, compared to 13 per 100,000 in the 1990s. Rising medical costs and high costs of rural-to-urban relocation are among the key reasons for this increase. Early planning for the “raining days” of old age has a significant impact on life expectancy and quality of life as a person ages.

Homeownership rates in many Asian countries are high compared to most Western countries. Breadwinners of Asian families spend their entire working life paying off housing debt. These families accrue substantial amounts of housing equity over the years, but have very little cash to support their consumption and medical needs at retirement.

Except where social security systems are instituted to support retirement needs of the elderly, many families in developing countries are not well-prepared for unexpected shocks triggered by illnesses and chronic diseases that come with old age. According to the housing life-cycle consumption theory, families will reduce housing consumption through various means, such as reversing the housing equity and tenure, and consequently switching to fund their consumption and medical expenses after retirement.

Another distinct characteristic of the housing market in developing countries is their predominantly high-density living environment due to rapid urbanization. Such high-density living situations have important implications on quality of life and real estate investment decisions.

The interaction among housing wealth, health conditions, quality of life and government policies in urban cities in developing economies is one of the critical drivers shaping the global real estate markets as well as urban development for the near future and beyond.

The literature on housing wealth, consumption and savings, and quality of life has been written predominantly in the context of the developed world and with this audience in mind. However, the socio-economic characteristics, cultural structures and beliefs among households in developed and developing economies are very different. The dominant tradition in Asian family and kinship systems is widely extended in contrast to the prevalence of nuclear family/bilateral systems in much of Europe and the United States. Earlier findings on housing equity and retirement spending of American families may not be applicable to Asian families.

The dwelling’s behaviours and welfare will change in response to any initial alteration of the built environment and the subsequent variation in their neighbours’ behaviours, especially in a high-density living environment. For example, when a high-rise building is attached to an accessible sky garden or other type of green space, residents are more inclined to interact with neighbours and/or family members. Consequently, there are more positive spillovers among the neighbours.

Studies show that residents living in a quarter with a desirable built environment for non-market interactions spend significantly more time in social events with their neighbours or families; Meanwhile, residents who spend more time in social interactions tend to earn a higher income or spend less time visiting doctors, ceteris paribus.

The interaction among housing wealth, health conditions, quality of life and government policies in urban cities in developing economies is one of the critical drivers shaping the global real estate markets as well as urban development for the near future and beyond.

High-density living situations [in developing countries] have important implications on quality of life and real estate investment decisions.
We urge government policymakers, academics and industry practitioners to pay due attention to such critical drivers for future real estate and urban development. In so doing, we aim to gain a better understanding of housing wealth and the ageing process, as well as the effect of these variables on quality of life, investment risk-taking behaviours of homeowners and subsequent economic growth.

Such a study could also help improve understanding of how Asian societies view ageing differently with respect to formal and informal financial support. In addition, the effectiveness of various housing and retirement policies in different Asian countries should be evaluated and compared. The relevant issues include subsidizing housing for young couples and informal transfer of wealth (bequest) from parent to child.

This opinion piece is based on ongoing research by Deng Yongheng, Fu Yuming, Lee Nai Jia, Liao Wen-Chi and Sing Tien Foo at the National University of Singapore.
No government regulatory bodies either predicted or took preventive actions against the economic disaster that we now term the Great Recession. The system of self-regulation by the financial services industry, with government providing only a “light touch” that had become the status quo, proved itself completely inadequate to foresee or prevent the crisis.

**Real Estate Finance and the Crisis**

The financing of investment in real estate – previously regarded as relatively stable, although always prone to the vicissitudes of the business cycle – became one of the flashpoints of the global financial crisis. Although the real estate industry, representing so many different asset classes (e.g. residential and commercial), as well as so many different financial instruments for investing in real estate, became a trigger of the Great Recession, it was not the chief cause. The chief cause of the Great Recession was the mispricing of risk, abetted by policy-makers at the central banks of the major national economies, who inadvertently encouraged and incentivized the banking system to engage in extreme risk-taking, with excessive borrowing and lending across multiple asset classes.

Towards a Post-crisis Risk Management System

Although systemic risks have existed throughout history, the degree of interconnectedness of global finance is perhaps the latest factor that has made these risks more systemic in the past decade. Although systemic risks have existed throughout history, the degree of interconnectedness of global finance is perhaps the latest factor that has made these risks more systemic in the past decade. Its contagion has spread from the financial services industry to sovereign nation states. A company like Lehman Brothers, or a country like Greece, has had the power to destabilize the global economy.

A new, post-crisis system of risk management that will prevent such future systemic catastrophes must begin with government and the well-informed regulation of banks. We, including stakeholders in the real estate industry, government and finance, have to accept a world of continuous and unpredictable economic volatility. No national or regional regulatory body or risk management system can deal with global risk and its ubiquitous economic and social consequences with total efficiency.

The recent spate of national and supra-national regulations (Solvency II, Basel III, Dodd-Frank Act, etc.) is focused on building shock absorbers into the system of international finance. This is to be welcomed. Basel III capital requirements represent one dimension of cross-border response (under which banks need to maintain a minimum tier one capital ratio of 4.5% – which is more than double the previous requirement) and have the potential to reduce some part of systemic financial market risk. Nonetheless, Basel III, on its own, will be insufficient to ensure predictable systemic risk management, let alone economic stability and prosperity.

The same applies to national responses; for example, the Dodd-Frank Act – which is focused on Wall Street reform – is a good example of a well-intentioned national response to wrestle with an interconnected, global financial crisis. This act empowers the US Federal Reserve System with the responsibility of monitoring systemic risk institutions, setting risk-management standards and watching individual companies. Although this act focuses on regulating US financial services companies, the current list of the 30 top financial institutions posing the most systemic risk to the world includes only four US-based banks: Goldman Sachs, JP Morgan Chase, Morgan Stanley and Bank of America.

Such acts and actions on bank regulation are a severe case of “locking the stable after the horse has bolted” or, put another way, rear-view mirror regulation. This type of after-the-fact regulation is at the expense of a more far-sighted global system of risk management.

Towards an Early Warning System

Our recommendation is that an approach to risk management should be focused on creating a global early warning system for potential crises rather than trying to correct the past systemic problems that caused the Great Recession. Such a system would constantly provide global analysis and information on the use of complex financial instruments for borrowing and lending in all types of asset classes, including all types of real estate asset class.

Such a system would need to be fuelled by transparent and available information
A clear recommendation must be for greater education of government and public institution officials charged with supervising the financial services market and mitigating systemic risk.

It was not a shortage of data that caused the traumatic events of 2007-2009, as data on the US housing market was available to governments and regulatory authorities before 2007. Instead, the main problem was that there was no “early warning” framework to use available information for analysing the systemic risks that were building up. Also, there was no analytical and communications framework to regulate the transactions between lenders and investors.

A few ideas for the future (linking government and the real estate industry):

- Avoid large policy swings (such as artificially low interest rates) that encourage excessive leverage
- Make commercial and residential real estate debt flows more transparent to both regulatory bodies and private market participants
- Make public planning transparent and building approval processes consistent
- Establish advanced policies for sustainable buildings (which pose an environmental risk for the future) that are related to levels of future return for real estate investors
- Ensure that taxpayers are not explicitly or implicitly liable to bail out real estate developers or financiers
- Clarify the role of deposit insurance and the role of governments as lenders of the last resort
- Re-examine incentives that have been shown to create increased risks and “moral hazard” for taxpayers (e.g. homeowners’ subsidies)

One of the other lessons of the Great Recession was that banks’ financial instruments became so complex and opaque that it was beyond the ability of regulators and examiners to understand them and, by extension, to signal the danger that was posed by them. We have had ample demonstration that government understanding of the economics of complex, structured financial instruments in general, and commercial real estate financial instruments in particular, has been very weak and uninformed, particularly in comparison to their knowledge of, say, the economics and market dynamics of local residential housing market.

National and regional risk management systems, like those described, are not staffed with a sufficient level of experts and professionals. The financial literacy of government officials and regulatory and credit agency staff, who failed to see the crisis coming, remains far weaker than that of the banks that they are now charged with supervising (with the intention of mitigating future systemic risk). A clear recommendation must be for greater education of government and public institution officials charged with supervising the financial services market and mitigating systemic risk.

History has taught us that government policy and regulation is vital to making such a risk management system effective. For example, during the period of the Glass-Steagall Act (initiated in 1933 and repealed in 1999), which separated deposit-taking and risk-taking institutions, only 5% of all mortgage lending in the US could be termed as “subprime”; following the repeal of this “inflexible” act, the volume of subprime loans rose to 30% in the United States.

We can also observe the effectiveness of strong regulation at the level of nation states. For example, the average Canadian bank, under a strong regulatory regime with higher capital adequacy standards, had a debt leverage ratio of 18:1. During the Great Recession, no Canadian bank went bust or needed to be bailed out. Canada’s US banking counterparts had a debt leverage ratio of 30:1 and were mauled by the recession, and many of them had to be bailed out by their government.

However, despite the primacy of government as a focus of reform, a major lesson of the Great Recession is that individual nation states, no matter how powerful, are incapable of solving such crises without multilateral coordination and action. There needs to be a framework of systematic risk management that is global, not just national or regional. National governments, and their regulatory bodies, acting unilaterally, have done little in the past decade to prevent the excessive lending, borrowing and risk-taking that caused the Great Recession.
Drivers of the Future Global Real Estate Financial Market

Every time a crisis happens, it is necessary to go back to basics to understand what went wrong. In relation to the last financial crisis, we need to visit not only the financial aspects in general, but also the basic principles that drive real estate issues.

The first is connected to the real estate asset value – the amount that a transaction of a particular real estate asset could realize under a certain conjuncture. This concept is important since, no matter the amount of the mortgage, the underlying real estate asset value remains the same if market conditions remain the same. As such, any price movements must be associated with differences in demand and/or supply, or with the environment characteristics or even the features of the product itself. Any other causes leading to an increase in price are artificial. This condition, and the incapability of buyers to pay rising mortgage payments, helped trigger the crisis and its ensuing consequences.

The second concept that must be revisited is related to investment analysis. Every time a real estate investment analysis takes place, it infers that it is necessary not only to run algorithms, but also to build a reliable set of scenarios under which the investment will produce different incomes and, as a result, different returns for a given portfolio. The effectiveness of the algorithm is essential but, to enable investment analysis, building scenarios using reliable information is fundamental. When scenarios are built under a very optimistic perspective, the results used for decision-making are unrealistic, thus resulting in inadequate decision responses.

When we combine these concepts with those from the financial market, such as securitization structures, the importance of transparent, reliable and consistent data for real estate investments becomes very evident, and can even warrant a new role for credit agencies.

Policy response framework must be formulated with the consideration of sustainability principles, with particular attention to population growth, urbanization limits and the use of natural resources. As for the new sources of capital and structures of investment, they are the most heterogeneous driver as they can vary greatly depending on the region. For example, in Brazil, finance sources have changed over time depending on the development type; in the 1960s, most of the big developments were financed by government banks. At that time, a financial system was created to finance housing and infrastructure needs. The system was based on the population’s savings and on a compulsory account to which employers and employees needed to contribute monthly. The high inflation rates that existed until the end of the 1980s compromised the real capacity of the system of financing housing, causing a depressing period for constructors, developers and, especially, buyers. During this period, pension funds were responsible for financing developments such as office buildings, shopping malls and hotels.

When inflation came under control, the system was rescued and, after some adjustments, was able to again finance housing. Today, credit has been expanded and represents around 4% of GDP in Brazil. Pension funds are now back to financing developments for long-term incomes after reducing their portfolio in real estate investments due to a government limitation policy for liquidity to those institutions.

Today, there is a range of capital sources for financing big developments, such as private companies, sometimes with foreign investors, Brazilian companies via IPOs and resources from the national development bank (BNDES, Banco Nacional de Desenvolvimento Econômico e Social). Although foreign investment in Brazil is still constrained due to the limited availability of transparent data, there is still considerable demand in many segments of the real estate market, and it will certainly benefit from global experiences on policies to create an efficient market for such foreign investments.

Artificial price movements] and the incapability of buyers to pay rising mortgage payments helped trigger the crisis and its ensuing consequences.
Real estate has a crucial role in the global financial markets, with major real estate investors including pension funds, sovereign wealth funds, private equity and endowments. However, the global financial crisis has had a major impact on real estate investing.

Prior to the financial crisis, the ready availability of capital saw high levels of debt utilized by many real estate investors. As we move out of the crisis, the clear investment priorities are for lower debt levels, effective risk management, conservative investments (e.g. core real estate portfolios), increased professionalism, simpler and more transparent investment structures, reduced return expectations and greater consideration of the impact of increased financial regulations. Real estate continues to be seen as an important, long-term asset class for major investors, as well as an essential element in the economic and social fabric.

A key ingredient is the changing landscape of global real estate investment. This will see a reshaping of global real estate financial markets in the future; providing much-needed sources of new capital, using a range of real estate investment strategies. Asia will be an increasingly important player; both as a destination for global capital and as a source of it.

First, pension funds have been major investors in real estate, with typical levels of 5-10% in real estate in pension fund portfolios in the mature Western economies. While Asian pension funds are among the largest globally, the levels of real estate in their portfolios are generally significantly less; often zero. This is largely because Asian pension funds focus on conservative portfolios dominated by fixed income assets.

This raises major concerns about Asian pension funds meeting their future obligations, which is further magnified by rapid structural changes in Asia, including:

- Demographic changes, such as an ageing population; this major demographic transition will occur over one generation, compared to over several generations in Western countries.
- Rapid economic growth, with significantly increased urbanization (e.g. China, India).

Fortunately, many Asian pension funds now recognize the impact of these critical structural factors and are strategically reassessing their portfolios. This includes an increased focus on international investment for portfolio diversification and on alternative investments, which include increased levels of real estate. Pension funds such as South Korea’s National Pension Scheme (US$ 240 billion) and Malaysia’s Employees Provident Fund (US$ 100 billion) are leaders in this area, developing global real estate investment strategies as key ingredients in their overall investment portfolios.

Other Asian pension funds are expected to implement similar strategies. Given the scale of these Asian pension funds, this has significant implications for increased new sources of capital for real estate investment, both in Asia and via global mandates (e.g. US, Europe).

Given the scale of Asian pension funds, [the rise in their investments in real estate] has significant implications for increased new sources of capital for real estate investment, both in Asia and via global mandates (e.g. US, Europe).

Second, sovereign wealth funds (SWFs), comprising nearly US$ 4 trillion in assets, are taking on more significance among global investors. Real estate has typically been a popular investment with the larger, more established SWFs (e.g. Abu Dhabi Investment Authority, Singapore Government Investment Corporation). Importantly, a number of SWFs are becoming actively involved in real estate investment (e.g. Qatar Investment Authority), as are some of the newer SWFs, such as China Investment Corporation, which are developing their global real estate strategies and making significant global real estate investments.

A key factor for both pension funds and SWFs in Asia is the increased use of effective risk management strategies. These strategies include co-investment/collaboration with other players for risk sharing, and the use of in-house and external professional expertise.

Third, real estate investment trusts (REITs) have rapidly recovered from the financial crisis after successfully recapitalizing and repositioning for increased future real estate acquisitions. With REITs in Asia (e.g. Japan, Singapore, Hong Kong) now accounting for 12% of the global REIT market of over US$ 650 billion, they are expected to play an increased role in real estate investment as the world moves on from the financial crisis.
estate investing in Asian countries and developing pan-
Asia real estate portfolios.

Overall, the real estate investment landscape has changed considerably since the financial crisis. In particular, Asian pension funds and SWFs are expected to play a significantly increased role in providing major sources of capital for real estate investment, both in Asia and globally. Strategies need to be developed globally to facilitate these increasingly important sources of capital from Asia to continue to support global real estate investment as the world moves on from the financial crisis. These strategies will be key elements in enhancing the stature of real estate as an essential ingredient in the economic and social well-being of communities globally.
The very basic drivers of real estate are rents and sale prices achieved. A robust system for data collection would be based on changes to real estate ownership and lease laws, such that no asset sale or lease contract would be valid without notarial registration and public publication of the key data of these activities.

Market participants might object on the basis that information disclosure could be commercially damaging. The response to this objection is that, in practice, well-informed brokers already have private information on these activities, so no additional harm is done if such notarial registration and public publication become mandatory.

However, an exception could be made for an asset that does not have registered mortgage financing. The rationale for such an exception is that the public good does not require disclosure of information that does not involve the financial system, which is ultimately backed by the public. Countries with relevant civil codes and notarial systems may have an advantage in implementing such a system.

One common concern about this recommendation is that some asset transfers would not be registered if effected via the sale of special purpose vehicles (SPVs) for tax purposes. This implies that transfer taxes must be set low enough to avoid being an impediment to transactions and anti-avoidance legislation must be watertight.

Good policies, governance and standards are the most important drivers shaping the global real estate financial market. The nature of the problem related to these drivers is quite simple: there is often too much debt and too little documentation. Good policies, governance and standards are the most important drivers shaping the global real estate financial market. The nature of the problem related to these drivers is quite simple: there is often too much debt and too little documentation. Therefore, the solution should be quite simple as well. Central banks should prevent regulated banks from taking real estate leverage risk above 80% loan-to-value (LTV) ratio, and should set a standard in terms of documentation.

Rating agencies’ ratings do not suffice if the documentation is not satisfactorily shown in the first place. Free-marketers may object that this stifles financial innovation, which may be true in isolation. Nonetheless, this objection misses the point that innovation involves risk, which should not be borne by the regulated financial system given that this risk is ultimately borne by the governments and taxpayers of their home countries.

Conversely, there is clearly a place to be taken by unregulated financial providers for mezzanine and non-conforming loans. Regulation would ideally be supranational, but political realities mean that, at best, we could achieve coordination only. This does leave some scope for capital arbitrage, but a given country could take the view that the risk of loosening regulations is just not worth the short-term return.

Moreover, real estate is not a commodity asset class that lends itself easily to standardization, despite several valiant attempts to address the challenge. Therefore, the success of a government-sanctioned, large-scale and robust derivatives market to hedge again risk is unlikely. While the Case-Shiller Index and similar work such as that of the Investment Property Databank (IPD) should be supported, these indices should be seen as only one part of a bigger solution set.

As for good policies to rescue a banking system in crisis after the collapse of a housing bubble, Sweden provides a valuable lesson in getting it “most right” in the crash of the 1990s. It took early actions to nationalize banks, created good bank/bad bank structures, set sensible time frames for resolution of the assets (not via fire sales) and established commercial incentives for the managers working out the problematic assets.

While some policies, such as social policies, may not have the real estate financial market as their primary policy objective, they nonetheless have a critical impact on the market. For instance, tax incentives for primary residence – a common social policy in many countries to promote homeownership – have created an enormous distortion in the market. These policies therefore should be included in the broader debate about good policies, governance and standards for the real estate financial market.

Last, the global real estate financial market has seen new sources of capital and structures of investment as a result of the financial crisis that are likely to be another major driver for the market. That said, the real estate industry is coping with the lower availability of debt much better than many pundits would have believed. There is no shortage of equity capital available from institutions, listed property companies or a robust system for data collection would be based on changes to real estate ownership and lease laws, such that no asset sale or lease contract would be valid without notarial registration and public publication of the key data of these activities.
even private equity funds with a focus on real estate. While the debt-dependent private equity industry has been bemoaning the lack of debt (as it undermines one of the key aspects of their historical business model), the rest of the market has gotten on with life and adjusted to a lower risk, lower return, lower leverage environment. The shift is not complete yet, and we will experience tremors for some years to come, but the functioning of the real estate markets has fundamentally shifted.

[Most of the global real estate financial markets have adjusted to a lower risk, lower return, lower leverage environment. The shift is not complete yet, ...but the functioning of the real estate markets has fundamentally shifted.]
Large Public Markets for Real Estate Price Risk

Robert J. Shiller, Arthur M. Okun Professor of Economics, Yale University, USA; Real Estate & Urban Development Industry Agenda Council

The availability of capital to drive the real estate industry is ultimately dependent on the kinds of risk management and price discovery that are available regarding real estate prices. The recent financial crisis was primarily driven by unexpected real estate price movements; movements that might have been hedged against and even revealed in advance if appropriate derivative markets had been securely in place.

The most fundamental thing that governments can do to prevent a repetition of the kind of crisis that has afflicted much of the world since 2007 is to encourage the further development of public markets in real estate prices that could provide both risk management and price discovery for everyone.

Better risk management implies that price declines in real estate would not have these same repercussions, whereas better price discovery means that the real estate industry would be less likely to pursue construction plans that are at odds with reality.

Most real estate builders and investors are not gamblers. They would protect themselves against price fluctuations if they knew how. Nonetheless, because they largely do nothing to protect themselves against their real estate price risks, in effect, they become gamblers.

There are beginnings of a market for real estate derivatives, notably with the derivatives that have grown up around the International Property Database (IPD) that began in the United Kingdom. However, the market is still not very large, and does not yet provide price discovery on major exchanges.

Futures markets in home prices were attempted by the London Futures and Options Exchange in 1991, without success. The markets have been very slow to develop since then. In 2006, the Chicago Mercantile Exchange in the United States created a futures market for single family homes in 10 US cities. This was based on the S&P/Case-Shiller indices that my colleague Karl Case and I developed, and that are now supported by Standard and Poor’s. That market is still running today. Nevertheless, the volume of trade is still too small for that market to provide a meaningful vehicle for hedging.

The problem is that real estate investors around the world continue to expose themselves to large risks by taking undiversified, leveraged investments in real estate. The same issues that created the 2007-2009 crisis are still with us. We are asking for a repeat some day.

Creating liquid public markets for large fundamental risks that have no such market today is one of the most important things that could be done to prevent a repeat of the kind of crisis we are still in.

Governments can do many things to encourage the initial development of such markets. First, and very simply, they can let it be known that they want such markets, and so investors know they will not do things in the future that might hamper them. Beyond that, they can provide initial subsidies to such markets, even if only in the form of tax incentives. Governments of the world can support the creation of private institutions; the government’s role in creating such institutions is to provide a public good, whose value to society exceeds any revenues that the private promoter who tries to launch such a product can ever hope to earn.

Once the markets pass the initial hurdles and get going, then the need for government help vanishes, and they can continue indefinitely. The problem has been a start-up issue: liquid markets do not develop precisely because they are not liquid when they are started.

Governments have to get past the crisis-era mode of curtailing and punishing existing financial activities and help the private sector conceive vital new activities.

To make such things happen, governments have to get past the crisis-era mode of curtailing and punishing existing financial activities and help the private sector conceive these vital new activities.

If and when we get such public markets for real estate risks operating on a large scale, it may soon lead to a variety of retail institutions that will allow real estate investors – both commercial investors and homeowners – to avoid unnecessary gambles. Moreover, the development of such markets in real estate prices could be the innovation that makes it practical for insurance companies to start ensuring the values of homes, and for mortgage lenders to couple home value insurance with their mortgage loans.

Creating the fundamental public risk markets – whose prices are made known to everyone and give public
indications of the outlook for real estate markets over short and long horizons, and allow risk management over the same array of horizons – is an infrastructure investment for the economy, every bit as valuable as other infrastructure investments that are talked about today.

The most fundamental thing that governments can do … is to encourage the further development of public markets in real estate prices that could provide both risk management and price discovery for everyone.
Global Challenges Require Global Answers
Hans Volkert Volckens, Managing Director, Hannover Leasing, Germany;
Real Estate & Urban Development Industry Agenda Council

The pre-crisis real estate industry was driven by various key fundamentals – a year-long appetite of investors that did not exclusively focus on risk-averse core real estate projects, the opportunity to take advantage of a regulatory environment that fostered cross-border capital flows, and a functioning syndication market where banks were able to take loans off balance that had been granted to the industry and end-consumers.

The effect of the crisis was a global and mutual lack of trust in market participants, as well as the recognition that liberalized real estate and financial markets do not sufficiently function, and could even create systemic risks, when not complemented by a defined regulatory framework.

Such a framework needs to foster the implementation, inter alia, of:

- a clear definition and allocation of (financial) responsibilities
- the creation of investment structures that can weather the real estate cycles
- a set of rules that prevent excessive lending (in relation to lender’s own equity, such as Basel III)
- legal measures to force the increase of financial instruments’ transparency

National economies that have been struck by a heavy economic crisis tend to react on a national level first. Stimulus programmes for the national economy, combined with stricter rules for exercising business, are being implemented rather quickly by individual states to overcome the heaviest impacts of the economic downturn. Only in a second step, nations organize themselves in the appropriate forums (G20, EU, etc.) to discuss global reactions and healing mechanisms. The implementation of such international measures requires sufficient time and consensus of decision-makers, thereby again recognizing numerous national views and necessities. Such recognition often leads to a dilution of the appropriate measures in the ongoing debate and the subsequent legislative process.

In contrast, investors act truly globally and allocate their funds on the basis of a defined risk return profile. International capital follows an investment opportunity granted by a specific market, taking into account the political stability of the country, the volatility of the individual market, and the legal and tax hurdles in that country. The investment opportunity qualifies where its specific risk is being rewarded appropriately, meaning that the prospective return for the investor reflects the inherent risks associated with such an investment accordingly.

The more state-focused view of national legislators and the truly global investment perspective of international investors may again create systemic risks when trying to define answers to overcome the current economic challenge. This is because both parties form their answers based on different rationales, aims, expectations and responsibilities. The mutual responsibility of a legislator cannot be compared with the bilateral responsibility an investor is confronted with, vis-à-vis his shareholder, for example. The process of taking and implementing a decision could not be more different.

This imbalance of global leadership, with fundamental principles on one side and the rational of international capital markets on the other, can only be overcome by a truly global approach by world leaders.

Such an approach requires the courage to define answers for global challenges before implementing national laws, and the will to find these global answers in a timely manner, and to accelerate the national implementation process once the answers have been found. In addition, countries must avoid competing against each other in this process by not implementing necessary regulations in order to benefit unilaterally from increasing capital inflows. Such unilateral behaviour would
undermine any global attempts to prevent investors’ regulation arbitrages.

Finding global answers first, and then implementing a corresponding national legal framework based on the decisions taken by the international community, certainly would be a new way of effectively responding to global risks. Reversing the status quo priority by taking international action before national action would be the appropriate answer to risks connected with truly global real estate markets.
Drivers of the Global Real Estate Financial Markets

Steven A. Wechsler, Chief Executive Officer, National Association of Real Estate Investment Trusts (NAREIT), USA; Real Estate & Urban Development Industry Agenda Council

Real estate investment trusts (REITs) were first created in 1960 in the United States to help make the benefits of investing in large-scale and well-diversified income-producing real estate widely available to individual investors. Over the decades, Listed Equity REITs in the US have posted competitive and strong investment performance relative to investment alternatives in the stock and bond markets as well as relative to direct investment in the real estate asset class through private equity real estate funds.

Even in the Great Financial Crisis, REITs demonstrated impressive resilience... partly due to REITs’ considerable access to capital, which provided confidence in the midst of panic and set the stage for future opportunistic investment; and partly due to the beginning of recovery in the commercial real estate economy. Over the past two and one-quarter years, listed REITs in the US have raised US$ 90 billion in capital, two-thirds of which is equity.

Why have listed US Equity REITs been able to post such strong performance numbers over time and show such durability during the financial crisis? The following are some of the lessons from the US REITs:

- **Use and Control of Leverage**: Listed US Equity REITs have used leverage – which is constrained by market expectations – over time in a manner that helped enhance and not jeopardize returns.

- **Liquidity**: Listed US Equity REITs effectively take illiquid real estate holdings and render them liquid in the hands of shareholders, thereby adding value to the investment equation.

In conclusion, low to moderately leveraged liquid real estate investment – undertaken with professional management, through a perpetual entity focused over time on generating and distributing income as well as on preserving and growing invested capital – is an effective way for individuals to save, generate current income and build wealth.

- **Fees**: REIT fees and expenses are, by far, the lowest when compared against various types of private equity real estate funds.

- **Business Model**: The model for listed US Equity REITs relative to private equity real estate funds may encourage strategic management since these REITs operate as companies with full-time internalized management and are in the business of buying, operating and selling real estate for perpetuity; invariably, there is a time to buy and a time to sell – listed US Equity REITs were net sellers of real estate during the last two years of the “bubble”, selling largely to private equity real estate funds in the business of fundraising, fund management and fund disposition.

- **Mandatory Dividend**: Perhaps most significantly, the use of capital by REITs must be highly disciplined due to the requirement of a REIT to distribute effectively all of its taxable income each year; thus, capital is not permitted to continually accumulate on the balance sheet, but must be replenished as needed under the discipline of public debt and equity markets.

The US experience with the REIT approach to real estate investment is worth full consideration around the world as policy-makers in a variety of countries look to build out the real estate investment marketplace and to provide a reliable way for citizens to save over time and invest for current income and long-term growth.

The Real Estate Investment Trust approach is worth full consideration to build out the real estate investment marketplace and to provide a reliable way for citizens to save over time and invest for current income and long-term growth.
About REITs in the United States

In the US, REITs today are companies that primarily own, often actively manage and sometimes finance the full range of real estate assets (which must be at least 75% of all the company’s assets). REITs that primarily own and rent real estate are known as Equity REITs; and REITs that primarily finance real estate through the origination or purchase of mortgages are known as Mortgage REITs.

In exchange for elective compliance with the REIT tax rules, including the distribution of most (90%) or all taxable income to shareholders each year, REITs are permitted to deduct dividends paid to shareholders from their corporate tax bill – resulting in one level of taxation at the shareholder level, rather than two levels of taxation. REITs in the US may be listed on national stock exchanges like other public companies; offered to the public, but not listed on stock exchanges; or completely private companies. In the United States, REITs may be managed internally by full-time employees in the same manner as other publicly traded corporations or managed by external advisers for a fee.

There are currently 155 REITs listed on stock exchanges in the United States, representing about US$ 430 billion in equity market capitalization and about US$ 700 billion in total market capitalization. Most of these firms are operating companies working through an internalized management model. By number, it is estimated that listed US REITs represent about 10% of all REITs and about 10% of commercial real estate in the United States. About 90% of the listed REITs in the United States are Equity REITs, and about 10% of them are Mortgage REITs.

Since 1960, the REIT approach to real estate investment has expanded around the world with about 35 countries, including Australia, Canada, France, Germany, Japan and the United Kingdom, now supporting a REIT-like real estate investment regime. Listed REITs outside the United States represent about US$ 250 billion in equity market capitalization, which is roughly equal to the level of equity market capitalization of listed non-REIT property companies outside the United States. Given the variations in law and custom around the world, REITs in Australia, Europe and the United States are viewed largely as real estate operating companies, while REITs in Asia are seen as more akin to real estate investment funds.

Over the decades, listed Equity REITs in the United States have posted competitive and strong investment performance relative to investment alternatives in the stock and bond markets as well as relative to direct investment in the real estate asset class through private equity real estate funds.

As an example, over the past 10-, 20- and 30-year time periods, listed US Equity REITs (as measured by the FTSE NAREIT US Real Estate Index) have turned in better compound annual total returns than the S&P 500 Index; the MSCI Europe, Australasia and Far East Index; the Barclays Capital US Aggregate Bond Index; and the Barclays Capital Global Aggregate Bond Index.

Relative to private equity real estate funds in the United States, listed US Equity REITs have also performed admirably. In fact, over the last real estate economic cycle (peak to peak over 17+ years), listed US Equity REITs provided a compound annual return, net of fees and expenses, of 13.4% – significantly better than the 7.7% of core private equity US real estate funds; the 8.6% of value-added private equity US real estate funds; and the 12.1% of opportunity private equity US real estate funds. During their respective “bull” market periods, when common wisdom would hold that more heavily leveraged value-added and opportunity private equity real estate funds would deliver stronger returns, listed US Equity REITs again outperformed.

Investment Attributes of Listed US Equity REITs

Listed US Equity REITs are not:

- Investment companies or mutual funds
- Closed-end funds
- Partnerships
- Exchange-traded funds (ETFs)
- Hedge funds
- Private equity funds

Listed US Equity REITs are known to be:

- SEC-registered
- Widely held
- Corporations (2/3) or trusts (1/3)
- Managed internally (90%)
- Moderately leveraged (40-45%)
- Mostly core properties (70%)
- Liquid investments (US$ 4 billion daily on NYSE)
- GAAP compliant
- Transparent
- Income-oriented (60% of total return via the dividend over time)
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As multistakeholder groups formed to advance knowledge and collaboratively develop solutions to the most crucial issues on the global agenda, the Councils represent transformational innovation in global governance. Specifically, the Councils monitor key trends, identify global risks, map interrelationships and address knowledge gaps. Equally important, Councils also put forward ideas and recommendations to address global challenges.

Council Members meet virtually and at the Annual Summit on the Global Agenda in the United Arab Emirates. Moreover, they are fully integrated into the broader Forum Community and are regular panellists in sessions at the World Economic Forum Annual Meeting, and at the Forum’s Regional Meetings and Industry Activities.

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