Investment in Property is Safe or Dangerous

1. **Sheer size of the asset class**.

   The aggregate value of property held by American households in the peak year of 2006 was $22.7 trillion, their biggest single asset by a wide margin (pension-fund reserves were next, at $12.8 trillion). Working out the figures in other countries involves much more guesswork. Back in 2002 this newspaper reckoned that residential property in the rich world as a whole was worth about $48 trillion and the commercial sort $15 trillion: if you allow for property-price changes in the intervening period, the current values, even after the bust, would be $52 trillion and $28 trillion, or 126% and 67% respectively of the rich countries' combined GDP in 2010. Whatever the precise number, property is so big that when credit conditions loosen it is likely to absorb a lot of the extra liquidity; and when something goes wrong the effects will be serious.

2. **Huge amount of debt involves**

   Most people do not borrow to buy shares and bonds, and if they do, the degree of leverage usually hovers around half the value of the investment. Moreover, when stock prices fall, borrowers can usually get their loan-to-value ratios back into balance by selling some of the shares. By contrast, in many pre-crisis housing markets buyers routinely took on loans worth 90% or more of the value of the property. Most had no way of bringing down their debt short of selling the whole house. Gearing in commercial property was lower but in the boom years it still regularly touched 80-85% (it is now back to 60-65% for new borrowing in the rich world).

   With only a small sliver of their own capital to protect them, many owners were quickly pushed into negative equity when property prices fell. As borrowers defaulted, the banks' losses started to erode their own thin layers of capital. Banks are leveraged and property is leveraged, so there is double leverage. That is why a property crash is a problem for the banks.

3. **Change in Fundamentals**

   Property bubbles almost always start because fundamentals such as population growth, interest rates and economic expansion are benign. A shrinking population weighs on Germany's housing market, for example, and a rising one underpins long-term confidence in America's. These fundamentals explain why many market participants are able to persuade themselves that huge price rises are justified and sustainable. Chastened regulators now talk about a presumption of guilt, not innocence, when prices look frothy. That is because property markets are inefficient in several ways which make it more likely that they will overshoot.

4. **Artificial Comfort to Lender**

Collateralized lending offers a degree of protection to the individual lender, but it has some unfortunate systemic effects. One is the feedback loop between asset prices and the availability of credit. In a boom, rising property prices increase the value of the collateral held by banks, which makes them more willing to extend credit. Easier credit means that property can sell for more, driving up house prices further. The loop operates in reverse, too. As prices fall, lenders tighten their standards, forcing struggling borrowers to sell and speeding up the decline in prices. Since property accounts for so much of the financial system's aggregate balance-sheet, losses from real-estate busts are likely to be synchronized across banks.

5. **Housing is both Investment as well as Consumable**

Borrowers, too, contribute to the inefficiency of property markets, particularly on the residential side. Some people think that renting will enjoy a renaissance as a result of the crisis, but few expect a wholesale, permanent shift in attitudes. Unlike other assets, housing is seen both as an investment and something to consume. In its latest survey of consumer attitudes in July 2010, Fannie Mae, one of America's two housing-finance giants, found that Americans wanted to buy houses for a range of reasons, from providing a safe environment for their children and having more control over their living space to making a financial return. In China there is another item to put on the list: for many young men owning a property is a prerequisite for attracting a wife.

This mixture of motives can be toxic for financial stability. If housing were like any other consumer good, rising prices should eventually dampen demand. But since it is also seen as a financial asset, higher values are a signal to buy.

And if housing were simply a financial investment, buyers might be clearer-eyed in their decision-making. People generally do not fall in love with government bonds, and Treasuries have no other use to compensate for a fall in value. Housing is different. Buying a home is a largely emotional one, similar to that of buying art. That makes it likelier that people will pay over the odds. Commercial property is a more rational affair, although hubris can play a part: there is nothing like a picture of a trophy property to adorn a fund manager's annual report.

6. Absurd Bid

Once house prices start to rise, the momentum can build up quickly. No single individual (except, perhaps, Warren Buffett) can push up a company's share price by buying its stock at an inflated price, but the price of residential property is set locally by the latest transactions. The value of any particular home, and the amount that can be borrowed against it, is largely determined by whatever a similar house nearby sells for. One absurd bid can push up prices for lots of people. **For example BPTP won the bid in Noida to buy the property which was 70% more than the reserve price fixed for that piece of land. The price was unmatchable.**

7. Speculation & Greed

As prices rise, property is arguably more likely than many other asset classes to encourage speculation. One reason is that property is so much part of everyday life. People do not gossip about the value of copper and tin, but they like to talk about how much the neighbor's house went for. They watch endless TV shows about houses and fancy themselves as interior designers, able to raise the price of their home with a new sofa and artful lighting. Eventually the temptation to take a punt on property becomes overwhelming. "Speculation is a bit like sex," says Robert Shiller of Yale University, a long-standing observer of speculative bubbles. "People who have lots of sex are not approved of but they are thought to live life with gusto. People eventually decided to try for themselves."

8. Property Instruments & Financial Innovations

There have been attempts to create instruments that allow property to be hedged or shorted. Such products are conceptually appealing but face several obstacles. Some are common to all financial innovations: new products lack enough liquidity to lure buyers in, for example. Others are more specific to property. Individual properties and neighborhoods differ, which makes it hard to construct accurate hedges. Government interventions to shore up the housing market add an extra element of unpredictability. And since house-price cycles tend to last for a long time, it can be expensive to sustain a short position.