Breaking Up
The Story Behind the Divorce of Real Estate and Capital Markets

Market Perspectives

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The real estate and financial market crashes of 2007 are the most recent empirical proof that imperfectly competitive markets do not trend toward equilibrium transactions of price and quantity. As businessman and currency speculator George Soros has frequently pointed out, "Financial markets have a tendency to develop bubbles." Real estate markets, too, will tend to overshoot and then undershoot equilibriums of price and sales volume.

But the distance between market and equilibrium values became very great as a result of the agreements that sealed the marriages between participants in real estate and capital markets in the decades before 2007. The capital participants in that marriage appeared to be respectable and wealthy, but they had skeletons in their closets. One skeleton, uncovered late into the marriage, was that many of the real estate loans packaged into the securities sold in capital markets were destined to fail. Another hidden secret was that very profitable derivative agreements related to the mortgages and other real estate loans were frequently underfunded. Even more insidiously, these derivative contracts covertly created a pattern of closely spaced dominoes of shaky financial firms.

For years, both partners in the marriage thought themselves well satisfied by the relationship. But the marriage became extremely rocky when many mortgage borrowers could not make the payments called for in the underlying individual mortgage contracts that had been packaged into the collateralized debt obligations (CDOs) traded in capital markets. As this happened, the years of mutual marital bliss faded into memory. Real estate inventories stopped selling, loans that real estate operators had thought would be easily renewed were called, and the assets of commercial banks, investment banks and insurance companies took a nose dive. The solvency of these firms came into question, and some major financial institutions were unable to cover the assurances made in derivative contracts they had signed.

The marriage was strained to the point where separations ensued, with neither party able to function normally. Prices in both markets plummeted, and transactions slowed to a crawl, affecting all the markets in the economy. As a result, both partners called for their Uncle Sam to bail out cash-short banking and insurance companies. Uncle Sam did step in to bail out what was recognized as the biggest financial mess since the Great Depression of the 1930s. Neither market was able to contribute to the broader economy, as the partners now were busy in divorce litigations before bankruptcy judges or at marriage counselors seeking to renegotiate or restructure the financial terms of their marriage contract.

Looking back to the years when the money generated by the marriage had pushed up real estate sales and values, it is clear that both parties had ignored danger signs. By the middle of the last decade, due diligence efforts that rated the repayment risks of the loans packaged into CDOs became increasingly sloppy. The real estate partners selling housing and the agencies rating securities with real estate as collateral closed their eyes to the reality that many of the borrowers had neither the income nor the credit history to substantiate the belief that mortgage repayment terms could be met.

Even more ominously, as housing prices continued to soar, the federal government let its concern for a possible fall in the rate of homeownership override its concern for prudent lending and rational behavior in capital markets. Successive federal administrations stripped away the many wise regulations imposed on financial institutions by laws and policies crafted during the presidency of Franklin Delano Roosevelt, which outlawed practices that had played a major role in causing the Great Depression.

The repeal a decade ago of the Glass-Steagall Act of 1933, which had separated investment from commercial banking, freed both commercial and investment banks to expansively create and trade mortgage-related securities. This expansion was facilitated by the large pool of dollars that became available as the United States consistently ran a large trade deficit, and foreign exporters bought trillions in U.S. Treasury bonds and securities from Wall Street. In what seemed like a financial perpetual motion machine to the those drawing huge bonuses in the banking industry, securities consisting of packaged and often repackaged mortgages were profitably sold without the investment banking firms having to put any of their own money into the transactions. As time went on, the mortgages that served as the collateral backing the CDOs became increasingly risky. To keep the home mortgages flowing, issuers offered "teaser" interest rates that led borrowers to sign on for mortgages with low initial payments that would jump up precipitously in future years.

By the time the marriage was in the divorce court, it was clear that derivatives did not effectively hedge against the systemic effects of mortgage defaults. The financial dominoes that had been stacked together by the derivatives fell. Particularly hard hit were firms such as the American International Group (AIG), which found itself unable to support the losses sustained as defaults within mortgage-backed CDOs shrank their asset base. These firms also lacked the cash to cover what they owed other financial institutions on derivatives related to real estate loans. Such firms were deemed "too big to fail" by officials in the Federal Reserve Bank and the U.S. Treasury, who realized, belatedly, that the credibility and continued functioning of U.S. and international capital market institutions were threatened. They bailed out the financial sector with billions of dollars, and poured trillions into the money supply in an effort to get the banking system to regain confidence and start making the prudent loans needed for the economy to climb out of recession.

It is too early to know whether the efforts to resurrect the confidence of lenders and stimulate the economy are sufficient to the task of putting the U.S. economy on a solid growth path. But it is clear that when that day comes, it will be imperative that mortgage lending and related derivative contracts, if they are to be allowed at all, be prudently funded and underwritten and traded only on exchanges that will enable those trades to be visible to all. Further, no bankers should be allowed to issue CDOs without some "skin in the game."

The time to install the needed laws and regulatory policies is now, before the divorced partners from capital and real estate markets remarry. And they will remarry -- because money is not only the life blood of politics, it is also the life blood of capital and real estate markets. It is important to understand why the marriage of the partners from the real estate and capital markets ended in divorce. As is the case in many real marriages, the estrangement of the partners affects a wide group of friends and family. Similarly, the crack up of the marriage between partners in the real estate and capital markets has done great damage to the broader society and the macro-economy. That is the reason we need to re-impose laws and policies to encourage happy and productive future marriages between participants in the two markets.

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