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The Real Estate Funding Gap

Markets do not operate in predictable ways. Take the most basic assumption of increased earnings – this can rationally increase an economic agent's propensity to work harder or to work less. Economists have labelled this the income or the substitution effect. The practical result of this we can only be certain of correlations and of consequences in the past. The economy is comprised of multiple economic agents who behave like pistons but an exogenous factor can send them either direction.

Ever since the onset of the financial crisis analysts have pointed to what they have called the funding gap in real estate. The funding gap is the need for refinancing of old, or the issuance of new loans versus the dearth in loan providers or of providers with sufficient lines of credit to satisfy demand. This is especially the case with the re-financing loans from the large run up of lending 2002 – 2007, which typically had a five or a seven year maturity.

Left to its own devices the funding gap in real estate would close itself through lengthening of the terms of outstanding loans, the increase in the price of loans, the increase of innovative / alternative forms of finance. What would disrupt this orderly closure of the funding gap in real estate are well meant but badly thought out political moves, these would change the rules of the engagement in real estate funding.

Clearly, nothing as important as real estate can exist in a political vacuum. This is all the more so as many feel that the real estate industry is responsible for the economic dislocation as a result of it absorbing so much value during the boom years. So it is natural to expect political pressure to pare down real estate exposure on the banks. This is codified and crystallised through the Basel rules – which successively have marked down the value of real estate assets to other asset classes due to its illiquidity (especially in a crisis).

So there is market pressure on the banks to decrease their historical exposure to real estate but also inter-governmental pressure to decrease their future exposure to real estate. If they do not carry through with this decrease, then all other things being equal, the general cost of loans will have to go up. However, the level to which this price goes up will dictate how many new entrants are attracted into the market whether insurance companies or other privately held lending vehicles. The extent to which these new participants can bridge the funding gap will dictate whether the fundamentals of the real estate industry are suppressed, supported or enhanced. No one knows which of these factors will prevail. And as with the general economy, funding can always become a self-perpetuating cycle. What does this mean to the real estate industry? The funding gap can be as much of an opportunity as a challenge as the ordinary course of financing is disrupted. In place financing needs to be secure for the immediate future and when it comes to new financing, all avenues needs to be thoroughly explored before long term arrangements are put in place.

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