

The Impact of Falling Property Prices on the Banking System and the Economy

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Introduction

The property market is an important component of a modern economy. Its primary function is to provide property space for economic activity to take place and for residential and recreational purposes. Ideally, the provision of such space should be in a timely manner, without creating market imbalances.

In a modern economy the property market is also an investment vehicle functioning alongside other capital markets such as the stock, currency or commodities markets.

Participants in the modern economy such as businesses, both small and corporate, need property for use, as collateral for business loans and this is the third and important dimension of property. Loans for property purchases, be it for investment or ownership, are based, *inter alia*, on the market value of the property. Market values can descend sharply, especially during severe economic downturns and at such times the underlying security value of loans in the banking system is threatened with the result that the banking system itself comes under threat.

The aim of this commentary is to highlight the issues in the property market arising from sharply falling property prices and its broad detrimental impact on the economy of a country. Recommendations are then made as to steps necessary to strengthen the system.

In this paper, wherever reference is made to the banking system it means the banking and financial system.

Loans Based on the Value of Property

In most countries, personal, business and project loans are granted with property as the underlying collateral. If property values then fall sharply such as during a severe economic downturn, the underlying collateral value of loans can erode and this can threaten the banking system, which in turn can impinge further upon the health of the economy.

Under normal circumstances, even during mild recessions, the problem is not serious, as property values tend to hold rather than slide. The banks conduct some foreclosures and a cleansing process gets underway but the system keeps intact. It is during severe downturns, and one which follows a period of overbuilding in the industry that the system falls apart, on the back of across-the-board sharp falls in property values.

The problem is even more acute for property projects where the property itself is the collateral. In many countries, including Malaysia, commercial and residential projects are pre-sold from the plan and whilst such a system works well during boom times enabling high project returns with good all round benefits for the industry, the drawback is that, during a severe economic downturn, the incomplete project can grind to a halt

leaving existing purchasers still on progress payments and lenders stranded with the project. To minimise project abandonment (which have in the past littered the property landscape at the tail end of a recession) many countries, including Malaysia, have instituted project accounting controls which check the misuse of funds collected on progress payments by the developer. However, the problem still persists because everything depends on good implementation and sometimes this is not done.

Participating lenders in such projects should adopt a more proactive stance in ensuring the continued viability of the project. They should monitor not only the progress of the project itself but also the state of the market as it changes.

Market Value as the Basis

In most countries, the collateral value of the loan is essentially based on market value (see IVSC¹ Standards) at the point in time before the loan is granted. Independent valuers who are on the panel of banks or who are acceptable as valuers to the banks ascertain market value. In some countries there is positive encouragement for banks to commission valuers directly. In other countries, valuers conduct valuations for clients who then take the valuation reports to one or a number of banks. When called upon to do so, valuers extend professional liability to the lending banks.

A limitation of such a system is that market value is time specific and as one moves away from the date of the last valuation the value of the property may change depending on changing market conditions or changes in material facts upon which the valuation was carried out in the first place.

To overcome this limitation, banks usually conduct periodic updates of the underlying security value of the loan, but generally the

guidelines for such updates are guidelines established within each bank. They can vary considerably. Within many countries and in many banks the guidelines on periodic updates can be absent or lax.

Notwithstanding the above it is also not sufficiently appreciated by banks that the system works best when the underlying security values are constantly kept under vigilance. The banks should be obliged to have their own guidelines on updates, keep track of the property market and take some responsibility in actively participating in the formulation of national property policies to ensure an efficient property market. Valuers have alleged that lenders are partly to blame for their own losses leading to the courts finding lenders liable for contributory negligence. Major grounds for successful pleas of contributory negligence by lenders have been failure to adhere to own lending policy or procedures, inadequate checks on the borrower, unquestioning reliance on the valuation and imprudent lending policy.

Rising and Falling Markets

Property markets operate in cycles. The cycles are at times short and at other times extended, depending on the overall state of the economy, fundamental changes such as changing demographics or changing household income levels or business profitability levels, unusual increases or decreases in supply of property space and other macro-economic parameters.

When a property market goes into a deep recession as has happened not only in the developing countries of the world but in the developed countries as well, prices can fall across the board and this impinges upon the stability of the banking system which in turn may affect economic growth.

The underlying collateral values upon which loans were given out diminish and the banks

are faced with a dilemma. To ask for additional security at such a time may not be beneficial. To foreclose would only result in exacerbating the negative conditions in the market and drive prices to even lower levels, into a vicious spiral, and this becomes particularly true when many of the banks institute foreclosure proceedings at the same time.

These unavoidable market gyrations become more acute when banks carry in their loan portfolios, loans whose underlying values are overstated due to the lack of proper valuations in the first place and the lack of proper and periodic updates.

For property projects there are usually the lack of proper and detailed market and feasibility studies and again the necessary periodic updates.

Recommendations

It is suggested that for the system to work the following needs to be observed.

The role of national policy makers

National policy planners must recognise the need for an overall property policy.

The overall property policy must promote, as a main objective, an efficient property market. Bureaucratic delays in approvals must be minimised or eliminated, costs of approvals must be kept as low as possible, planning approvals must be based on transparent zoning laws and/or physical plans, a free flow of information in the market must be promoted, efficient supporting industries such as for building materials and skilled labour must be created and maintained and there must not exist undue hurdles for new participants to enter the market which fosters competition with its attendant benefits.

Many countries still labor under inefficient markets as evidenced by distorted prices. In

some countries artificial property markets are created and maintained by restricting supply either by tight zoning laws or tightly controlled land release systems. Eventually when the bubble bursts there are disastrous consequences for all.

An efficient market will deliver property space to the market in the most timely manner. It will minimise extreme price swings and bear balanced relationships with long-term sustainable household incomes in the case of residential properties and with sustainable business profits in the case of commercial properties. House prices should bear a balanced relationship to household incomes and commercial rents should not be lopsided in the balance sheet of businesses.

The role of central bank supervisors and managers of lending institutions

Central Bank supervisors and managers of lending institutions should insist that financial institutions in giving out loans must ensure that valuation reports meet the following contents:

- That the valuation reports submitted to the bank or financial institution are current and not outdated.
- That the valuation reports are carried out for the purposes of obtaining credit facilities and not for other purposes that may either render it less useful for financing purposes.
- That the valuation reports are from suitably qualified valuers.
- That the reports are from valuers capable of extending adequate professional liability.
- That the valuation reports are carried out to professional standards as

established by professional organisations and/or regulators.

- That the valuation reports are updated from time to time.

For project loans, the following should be additionally adhered to:

- That a proper and detailed market and feasibility report is conducted.
- That such a report is conducted by properly qualified property professionals who are well versed as to the framework and economic condition of the property market.
- That there are sufficiently trained personnel in the financial institutions to understand, question and accept or approve such reports.
- That the reports are updated from time to time.

The role of valuers, professional valuation associations or institutions and regulatory authorities

Valuers, as well as professional and regulatory bodies should promulgate and uphold high professional standards including the minimum content of valuation reports.

Conclusion

In conclusion it ought to be appreciated that the banking system as it has evolved hinges upon a stable property market functioning in underpinning collateral values. The creation and maintenance of an efficient property market should be high on the policy objectives of national policy planners. Valuers play a central role in the property market, and professional organisations and regulatory authorities overseeing the valuation profession should not only be aware of their heavy responsibility in maintaining high professional standards but also in fact take continuous proactive steps in regulating the profession. □

Endnote

¹International Valuation Standards Committee