The integration of property and financial markets

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Received 17 October 1992; in revised form 17 July 1993

Abstract. In this paper, the nature of property and the growing links between property and financial markets are addressed. It is argued that property must be viewed as a commodity with use-value and exchange-value aspects. Property has been affected by two developments in the 1980s: the shift to services (especially financial services) and waves of deregulation. The increase in demand during the 1980s boom stemmed both from investors such as property companies and from end users, especially those engaged in or expanding into securities business following Big Bang. As property markets, including the housing retail finance circuit, became increasingly intertwined with wholesale financial markets they became more susceptible to the vicissitudes of these markets and tendencies toward crisis. The exchange value of property became disengaged from its use value as property took on the attributes of a quasi-financial asset.

1 Introduction
In the early 1990s the international property market finds itself in the throes of one of its worst crises this century. Prices of all types of property have collapsed across the major capitalist economies, resulting in negative equity for many homeowners (BEQB, 1992a, pages 266-268) and in widespread losses on commercial real estate. The latter result is borne out by the fact that a host of companies in construction, building materials, and property are going bankrupt or are experiencing severe financial difficulties. Notable casualties in the United Kingdom have included Rosehaugh, Mountleigh, Olympia and York, and Speyhawk. The price collapse has affected all sectors of the property market, including residential property, but the urban office market especially has experienced sharp declines in prices. The collapse of office values has affected virtually all European cities, but it has been particularly acute in London and Stockholm: a drop of some 50% in each case (Financial Times 1993, page 2). It should be noted that the current crisis also extends to the USA and Japan, the latter of which witnessed a remarkable speculative boom in the late 1980s.

The relative prosperity of the property market is important for several reasons. First, although the property and financial markets have always been interconnected, they are increasingly being integrated, but the precise extent of integration is a matter of dispute. There is thus a perceived threat that the property crisis may exercise a domino or contagion effect on the financial markets. For instance, the price of the ordinary shares of the National Westminster Bank fell by 10% in late August 1992 after disclosures that its residual loan book had sharply deteriorated. Second, orthodox economists are pinning their hopes of an end to the current recession on a consumer-led boom stemming from a recovery in residential property prices. This wealth effect indicates the centrality of the property markets for the conduct of macroeconomic policy. The third reason for the pertinence of a healthy property market is a more ideological one. In the 1980s, neoliberal governments in several advanced economies promoted the growth of a property and stock owning democracy. In the United Kingdom, successive Thatcher administrations espoused this
cause through a series of policies such as the sale of municipal housing and the privatisation of public sector enterprises (Coakley and Harris, 1992). Rising share and property prices underpinned this project; stagnant or falling prices are likely to have the opposite effect and thus call into question private property relations.

A central feature of this paper is the view that property is a commodity and thus must be considered as both a use value and an exchange value (Haila, 1988). Property serves as a use value to end users as diverse as workers and multinational corporations, but it is typically regarded as an exchange value by financial investors such as insurance companies and pension funds. This distinction between use value and exchange value mirrors that between occupier and investment markets made in orthodox analysis, but this is only part of the duality. A proper understanding of the changing nature of this duality is crucial in any effort to unravel the major processes underlying the growing links between property and financial markets in the advanced capitalist economies.

In the occupier markets the focus is normally on factors influencing the demand for and supply of property by end users, and so concerns the role of property as a use value. The major development in this respect in the 1980s was the increased demand emanating from financial and business services firms. However, even in occupier markets the exchange-value aspect asserts itself in times of booms as an increased propensity to trade or change premises, as we shall see in the next section. In investment markets, by contrast, the exchange-value aspect is invariably the major concern. This is the case even if some investors view property as a long-term investment, as enhanced (rental) income streams translate into increased exchange values. Deregulation in the 1980s has served further to blur the boundaries between both markets as did developments such as the rise of mortgage-backed securities in the USA.

In the next section, I consider the complexity of the nature of property both in terms of use value and exchange value and in terms of occupier and investment markets. In section 3, I focus on the commercial property occupier markets by examining the effects of Big Bang on the role of property as a use value for financial services firms. In section 4, I seek to identify and analyse the main elements of deregulation which led to a deepening of the links between real estate and financial markets in the United Kingdom. Conclusions are presented in section 5.

2 The complex nature of property

In the following sections I define property as buildings on or improvements to land. In the literature, land and property thus defined are often conflated by usage of the term 'landed property'. My purpose in separating land and property is to avoid here a direct treatment of the vexed question of urban land rent, as this merits a separate paper (for a sample of recent contributions on rent, see Budd, 1992; Haila, 1991; Houghton, 1993). Nonetheless, I shall have cause to refer to the rent question in passing. As Harvey (1982) and Haila (1988), I assume that, in capitalist economies, property functions as a commodity. However, I differ from them in qualifying their view of property as a pure financial asset. Property as a commodity has both a use value and an exchange value. The differences between the occupier and investment markets mirrors, to some extent, this distinction. Property, as with land, is no ordinary commodity but is instead extremely complex. At times it appears to take on the characteristics of a financial asset, but this, of itself, is not sufficient to establish property as a pure financial asset. Below, I propose the idea of property as a quasi-financial asset.
2.1 Property as a use value and an exchange value

The duality of property or real estate as both use and exchange value is more complex than in the case of many other commodities, partly because of its inherent nature and partly because of the increasing integration between property and financial markets. The dual nature of property leads to the important distinction between the occupier and the investment commercial property markets. Property serves predominantly as a use value to end users or occupiers as diverse as corner shops and multinational corporations. All use land and buildings in the course of their day-to-day operations. Nonetheless, the boundaries between the occupier and investment markets are neither clear-cut nor static. During boom periods of the property cycle the exchange-value aspect of all types of property asserts itself as an increasing tendency on the part of residential occupiers to move and of financial investors to trade. For instance, at the peak of the property boom in 1987 and 1988 the investment institutions were trading the equivalent of 25% of their portfolio value as compared with only 10% in 1981 (IPD, 1992, page 102).

At the end of 1990 it was estimated that a total of some £250 billion of commercial property was privately owned in the United Kingdom (all data from IPD, 1991, page 103). The split between the occupier and investment markets was put at 60:40. In the occupier markets, industrial and commercial companies owned some £135 billion of operational properties, and others a further £15 billion. For certain types of companies, such as banks, building societies, and the retail chains, property is a particularly important asset. Banks and building societies owned some £10 billion worth of properties at the end of 1990 (IPD, 1991). Indeed, such is the significance of property on the balance sheets of such companies that they are beginning to manage property as a separate asset and as a potentially profit-making activity. Again, this illustrates the complexity and fluidity of the duality between use and exchange value. It further indicates the significance of the exchange-value aspect of property even in the occupier markets.

The investment institutions alone accounted for some £55 billion of the total of £100 billion owned in the investment markets at the end of 1990, and this underlines their central role in property markets. For financial services conglomerates, such as multinational insurance companies, an office block can simultaneously serve both as a use value and an exchange value; that is, these conglomerates can occupy prestigious office blocks in central business districts which can count as significant assets in their own right on corporate balance sheets. Nonetheless, it is fair to say that institutional investors are primarily interested in property qua investment, and the total return it yields over the holding period as compared with other asset classes. For them, the exchange value or financial investment aspect of property predominates, for the most part, over the use-value aspect, whereas the opposite tends to be the case for individuals operating in the residential property markets. Evidence consistent with this is presented by Barras and Ferguson (1987), albeit within a different framework. They found that investment demand determined returns, capital values, and yields for industrial and commercial property, whereas user demand exerted the strongest influence on residential property.

2.2 Property as a quasi-financial asset

Although commercial real estate counts as a physical asset, it also possesses many of the characteristics of financial assets. Thus, the buying or selling of existing office blocks can be defined as financial investment in which the motive is to maximise investment income where income is broadly defined to include capital gains as well as rental income. Financial investment involves a change in ownership
and a redistribution of existing surplus value rather than the creation of new surplus value. Insurance, property, and other companies demand property as a financial investment as it serves as a store of value and historically has been viewed as an effective hedge against inflation in periods of rising prices. This may partly explain the decline in institutional investors' demand for property in the 1980s as low inflation became the norm.

Financial investment in commercial property differs from such investment in other financial assets in several ways. First, prime commercial property is far more imperfectly substitutable than are various blue-chip securities. The lack of substitutability of property is crucially linked to its location and to a host of other use details which render it immobile. Second, property lies toward one extreme of the liquidity-illiquidity spectrum, despite the fact that its liquidity premium displays considerable variation over the commercial property cycle. During booms, property increases in liquidity because of the ease of buying and selling, but, equally, it can become virtually illiquid in times of crisis. Even in the midst of booms, the legal and other administrative complexities involved in buying and selling real estate entail considerable search and other transactions costs, as well as delays in effecting the change in ownership. These complexities are exacerbated during crises. The collapse in October 1991 of the short-lived property futures market on the London Future and Options Exchange (FOX) indicates some of the difficulties involved in overcoming this illiquidity (Case et al, 1991). A final difference between property and other financial assets is its indivisibility, which in turn is related to its relative illiquidity. Unlike most other financial assets, commercial property cannot yet be widely traded in small units. Various attempts have been made to overcome this lack of divisibility, such as the development of property unit trusts and property income certificates (Fraser, 1989). Moreover, indivisibility plays a crucial role in disposing of large blocks of property as compared with large blocks of equity. Equity can be sold in small tranches over times so as not to depress prices, but this option is not normally available in the case of property blocks.

Despite the above differences, one can identify several parallels between commercial property and ordinary shares, representative of the class of risky financial assets. First, the manner in which the intrinsic or fundamental values of commercial property and shares are evaluated are very similar. In both cases, in orthodox analysis it is assumed that price equals intrinsic value as represented by the capitalisation of income streams: dividends in the case of shares and rental payments in the case of property (inclusive of capital gains). However, in the case of shares there is a growing chorus of dissent on the concept of market efficiency or the notion that share prices reflect fundamentals only (Coakley, 1991). In recent years other theories such as speculative 'bubbles' and 'fads' have been advanced to explain share prices, and these could equally be applied to property prices. Second, the income streams from shares and property are effectively smoothed over time, although the process of fixing rents over review periods may be rather more formal. Capitalisation rates, which can be seen as risk-adjusted interest rates, are crucial for both in translating future income streams into estimates of current fair value or price. It is the common role of interest rates which helps to explain the cyclical tendencies in both markets and in their general comovements.

The above parallels between property and financial assets may be seen as one basis for identifying property as a financial asset, but this is to ignore the differences already identified. Some authors advance different reasons for regarding land and, by extension, property as a pure financial asset. [Harvey (1982, page 348), although not dealing with property as such, treats land as a pure financial asset.] The main
reason identified is the involvement of interest-bearing capital in property; an involvement which, of course, cannot be denied. They also (and correctly in my view) view rent as having a positive coordinating role in the allocation of competing land uses. However, the view of property as a pure financial asset would seem to deny a specific role for rent in theorising property (which seems essential), for it is difficult simultaneously to reconcile the conflicting dictates of rent and finance theory. Instead, I would argue that commercial property is best regarded as a quasi-financial asset in which rent still has an explanatory role. It is a quasi-financial asset because it possesses some but not all of the characteristics of other financial assets. Its remaining characteristics are to be explained by the nature of rent and by Ball's (1985) structures of building provision. One of the implications of commercial property as a quasi-financial asset is its price volatility, and this will be discussed in section 5.

If property is a quasi-financial asset, then its price is potentially speculative in nature and thus subject to sharp changes of direction as bear markets succeed bull markets. This boom–bust property cycle is borne out by the UK evidence of recent decades (Ambrose and Colenut, 1975; Marriott, 1967). The Barber boom of the early 1970s was followed by the secondary banking crisis and by the collapse of property companies and property values. The property boom of the late 1980s lagged the bull market in securities, which was sharply interrupted by the October 1987 stock market crash. The late 1980s boom was followed by the property crisis of the early 1990s, one of the principal casualties of which was the City of London and the Canary Wharf complex. Its impact has also been felt in the property markets in the USA, Japan, France, and other advanced economies.

3 The shift to financial services
Investment demand for property in the 1980s was relatively weak, and property declined in significance as a proportion of institutional investors' total assets. Despite the weakness of investment demand, a boom in property began in the mid-1980s and lasted until 1990. The genesis of this boom has to be largely explained both by user demand emanating from financial services firms which were expanding rapidly in the 1980s and the response of property companies and banks. The role of property companies is extensively treated elsewhere (Pryke, 1993), so I focus here on user demand.

The mushrooming of the services sector in the United Kingdom raises many interesting questions concerning the emergence of the postindustrial society, the decline of Fordism, and the possibility of a services sector dynamic which is distinct from industrial production (Allen, 1992). Within services generally, business and financial services (hereafter simply called financial services) can readily be identified as the most significant sector. It is crucial to unravel trends and developments in the financial services industry to appreciate their impact on property markets during the 1980s and the early 1990s. In turn, one can differentiate between retail and wholesale financial services, as their spatial impact on property has been sharply distinct. Retail financial services are basically supplied to individuals and small companies in spatially diffuse outlets. Building societies are a good example of suppliers of retail financial services, and their role in the restructuring of financial services has been examined elsewhere (see Gentle et al, 1991; Leyshon et al, 1989; Marshall et al, 1992).

Wholesale financial services are services provided to large capital such as multinationals and state organisations. Typically, the suppliers are financial services multinationals which operate primarily from large conurbations or what Amin and Thrift (1992) have elsewhere called the nodes of global filieres. One might wonder
at the relevance of this distinction for property markets. Although the retail and wholesale financial markets were both fundamentally restructured in the course of the 1980s, one could argue that both the scope (which was cross-border in most cases) and the scale of the restructuring of wholesale markets was of a higher order of magnitude. This fundamental restructuring led to a new source of user demand for offices and appeared to provide extensive and potentially profitable opportunities for property developers.

Private sector property developers concentrated their prime property investment where market forces dictated that user demand would be greatest and profits highest; that is, in office development in the City and central London where the effects of a dramatic restructuring of wholesale securities markets in the wake of Big Bang were most acutely felt. This is not to deny that other projects in the United Kingdom, such as the MetroCentre in Gateshead or inner-city regeneration in Glasgow, were not significant. Rather, the point is that patterns of property development are both selective and uneven, and from the mid-1980s the major new source of demand was emanating from the City. For these reasons, I will next focus on the role of office development in London.

3.1 London's expanding international role

The boom in financial services over the course of the 1980s generated a new source of effective demand for prime commercial real estate as a use value in London and especially in the City. Property companies were quick off the mark in an attempt to take advantage of this new source of demand. To understand why financial services companies have been the major sources of demand for new and refurbished commercial property in the past decade in London, we need to explain the expanding international role of the City. The forces contributing to the spatial growth of London as an international financial centre have resulted in an enormous concentration of financial power and activities within the Square Mile and at its fringe (Sayer, 1992).

Traditionally, the City of London has enjoyed the centripetal forces which have led to the concentration and consolidation of financial power there since the heyday of Britain's imperial role during the gold standard (Coakley and Harris, 1983, chapter 3). Of all international financial centres, the City can boast of the largest representation of overseas financial services firms, creating a truly cosmopolitan industrial atmosphere (Amin and Thrift, 1992). This is because London's main role is an entrepôt financial centre whereas that of its principal competitors (New York and Tokyo) is based on servicing large domestic industrial bases (Coakley, 1992). Although some overseas firms have been established in the City for over a century, the main influx commenced in the early 1960s with the development of the Eurodollar market. Until the early 1980s the City's office stock had readily coped with the continued influx of overseas financial services firms and the activities they conducted in the expanding Euromarkets. The syndicated-loan Euromarket activities implied by unit banking (wholesale banking with a limited number of units concentrated in large cities) as opposed to branch banking made no new specific demands in terms of office space or equipment, and neither did the Eurobond market (for an elaboration of the argument that Eurobanking markets involve an internationalisation of the US system of unit banking, see Coakley, 1984). This changed dramatically in the mid-1980s with the deregulation of securities markets—the Big Bang.

Subsequent developments in City property markets in the 1980s can be interpreted as a fundamental restructuring of the old spatial matrix of the City of London, to use Pryke's (1991) terminology. The cosy village or club atmosphere of the
old City was being undermined and challenged by developments in new technology in securities markets and less deferential behaviour on the part of new overseas entrants, which implied that incoming financial services firms did not have to choose locations contiguous to the Bank of England as had been custom and practice up to the late 1970s and early 1980s. The Bank of England's traditional City view was echoed by the City Corporation as late as 1984 in its draft local plan in which it was proposed to preserve most of the old City's built form as a conservation area (Pryke, 1988). The Corporation's subsequent change of heart could be seen as further proof of the demise of the old City.

The problem in the mid-1980s was that the existing stock of office accommodation within the old City was unable to meet the demand for new property specifications such as large trading floors and flexible office floorspace. The new demands arose directly from the restructuring of the City's wholesale securities markets which the Tory deregulation policies of the 1980s entailed. This restructuring stemmed from a radical change in the nature and operation of stock markets which followed Big Bang. Foremost among these was the stampede by banking and securities firms to participate in securities markets (Goodhart, 1987). However, these new entrants' demands for accommodation ran up against the City Corporation's planning restrictions on new office provision within the traditional Square Mile or old City. The perception was that the information and communications technology underlying the new decentralised equity trading arrangements resulting from Big Bang would enable securities firms to break free of the traditional physical proximity bonds which the old Square Mile imposed. It was this and the Tory government's enterprise zone in Docklands which spawned the Canary Wharf complex.

In response to these new demand pressures the City Corporation did a U-turn on its traditional conservation policy and decided in 1986 to ease supply restrictions in the form of laxer planning regulations. Because of the long, albeit diminishing, lead times in large-scale property developments and the forces of inertia, property companies continued to supply new office accommodation long after demand had peaked. To appreciate the significance of this one needs to examine the impact of Big Bang on the trading arrangements for equities in London.

3.2 Big Bang and the restructuring of trading systems

Securities trading systems in most advanced economies were fundamentally restructured in the 1980s (Pagano and Roehl, 1990). This restructuring has had far-reaching implications in terms of the nature of trading arrangements and the knock-on effects on property markets. Essentially, what has happened is that stock exchanges are being transformed from natural monopolies to contestable markets in which new information and communications technology systems and private trading floors play a crucial role. Up to 1986 virtually all equity trading was transacted on the exchange on which the stocks had their primary listing. Since then, competition between markets has been encouraged both by increased cross-listing of securities (listing on several exchanges) and by cross-border investment in securities. In fact, the impetus for the agreement on the formal UK Big Bang provisions between the Stock Exchange and Cecil Parkinson, the Secretary of State for Industry, was the competition being provided by US exchanges for the trading of UK shares by US investors. Prior to the growth of formal cross-listing of shares it was possible to trade certificates for UK (and other overseas) shares in the USA in the form of American Depositary Receipts (ADRs; for a simple explanation of ADRs, see Francis, 1991, chapter 25). The trading of UK shares in ADR form in the early 1980s was bypassing the London stock exchange, posing an obvious threat to the
large UK stock market players. For this very reason the large players mostly supported Big Bang, but some opposition stemmed from the smaller and provincial stock exchange firms.

Big Bang in London occurred amid the euphoria engendered by the 1980s bull market in securities and by the brave new world being ushered in by widespread deregulation in the advanced capitalist countries. In this heady atmosphere the concept of the global financial conglomerate came to prominence. The financial conglomerate was seen as the supermarket or hypermarket of the financial world, providing one-stop financial services to multinational clients. The world’s leading banking and securities houses aspired to this status, as the alternative was, at the time, perceived to be second-division, niche banking. Most significantly, only London among the leading global financial centres permitted the emergence of these giants, as banks were prohibited from transacting securities business in both New York and Tokyo. The London offices of financial services firms in many cases came to be seen as icons reflecting the arrival of a new era of global financial conglomerates.

It is interesting to bear in mind that the Big Bang provisions contained no specific proposals or stipulations for securities trading arrangements. What resulted within a mere six months of Big Bang was a radically new trading structure which made the old Stock Exchange trading floor redundant. Recall that the traditional trading floor was a spatially centralised arrangement for the buying and selling of securities in which physical proximity, informal networks, and a club atmosphere played a critical role. The effect of the new dealership trading system based on the ‘Stock Exchange automated quotation’ (SEAQ) price-display system adopted in London post-Big-Bang was to lead to a spatially fragmented and relatively anonymous trading system. Instead of the traditional stock exchange trading floor, a decentralised over-the-counter (OTC) trading system emerged based on SEAQ, telephone, and telex. OTC trading is a somewhat anachronistic description for a type of modern securities trading. Its origins go back to the days when shares not publicly quoted on stock exchanges were traded over the counter by securities firms. Instead of having seats on the stock exchange trading floor, securities firms were formed to duplicate stock exchange functions in-house by the use of new dealing rooms and associated ICT accoutrements.

These open-plan dealing rooms with rows of desks cluttered with banks of monitors and Reuter’s and Telerate screens flashing the latest news onto enlarged wall screens became one of the hallmarks of the 1980s. Television news items on financial markets invariably showed the hurly-burly of the markets with short-sleeved young dealers simultaneously shouting into several telephone sets in front of rows of computer screens. Unfortunately, as far as the old City was concerned, such dealing rooms also needed specific provision in the form of large, open-plan, load-bearing floors with high ceilings, which most of the existing office provision could not deliver. So the perceived need for extensive new trading floors by the aspiring financial conglomerates was the major source of new occupier demand for office space in the City and its environs in the 1980s. The large US investment bank, Salomon Brothers, had stretched the new definition of the extended City furthest by deciding to locate next to Victoria Station in 1982. In the late 1980s, new development schemes involving large parcels of land emerged on the old City fringes. These included the 29-acre Broadgate complex next to Liverpool Street Station, and several schemes on London Wall, such as the innovative Alban Gate complex which involved building over the London Wall. In addition, the interiors of listed buildings were gutted, reinforced, refurbished, and reequipped with the ICT systems, as in Finsbury Circus and St Martin’s le Grand.
Unfortunately, the dream of financial conglomerate status for most firms involved in securities trading was sharply undermined by the October 1987 stock market crash and the subsequent bear market in securities worldwide. After the crash, turnover in securities trading in London halved. It soon became apparent that Big Bang (like many other instances of deregulation) had led to severe over-capacity in securities markets in London, and many firms were subsequently forced to retreat from these markets. The source of user demand which provided the initial stimulus for the 1980s property boom in the City and its environs was in decline from 1988 onwards.

4 Deregulation in the 1980s
Historically, links have always existed between property and financial markets. I will argue below that deregulation in the 1980s led to the deepening of financial links between real estate generally on the one hand and the financial markets on the other, despite the relative decline in institutional property holdings. The 1980s marked the demise of traditional Keynesian state intervention as pursued by post-war social democratic governments and heralded in new neoliberal regimes in which bonfires of controls were designed to unleash the full potential of relatively deregulated markets.

Deregulation involves the breakdown of barriers not only within and between financial markets but also between financial and related markets, such as property and commodity markets. In addition, one can view the liberalisation of planning controls as part of the wider deregulatory process. One of the less welcome results of deregulation is that, by artificially promoting competition in a laxer environment, it induces an increased turnover of assets and price volatility. This explains why the exchange-value aspect of real estate—including residential real estate—came to predominate in the boom during the late 1980s.

4.1 The abolition of exchange controls
Massey and Catalano (1978) were among the first writers to detail the significant role of the investment institutions in property markets. Since the creation of the standard institutional lease in the 1960s, insurance companies and, more latterly, pension funds have seen property as one of their major asset categories, alongside equities and government securities or gilts. However, the perception of the relative attractiveness of property altered dramatically in the 1980s as a result of one of the early acts of deregulation by the first Thatcher administration in 1979: the abolition of exchange control in the United Kingdom. The significant point to note here was that, prima facie, this had nothing to do with property per se. However, when combined with the laxer regulatory environment within which the institutions operated —permitting them greater freedom in accumulating overseas assets—the abolition of exchange controls was to have a marked impact on their investment behaviour.

From 1979 the institutions came to view overseas equities (and, to a lesser extent, overseas real estate), as a competing asset category which should be included in their portfolios on the basis of the principle of international diversification (Grubel, 1968). It will be seen later that corresponding deregulation in other EC member states as part of the 1992 programme may counteract some of the effects of the 1979 deregulation.

Tables 1(a) and 1(b) give the major asset categories held by UK pension funds and long-term insurance companies for selected year ends for the period 1979 (1991 being the most recent date for which such stock data are available; hereafter, for brevity, this period will be referred to as the 1980s). They reveal significant
parallels but also some interesting distinctions between the portfolio composition of and rebalancing by pension funds and insurance companies in the course of the 1980s. For both types of institutions, the significance of UK and overseas equities grew over the 1980s, but the growth rate of overseas ordinary shares was much more rapid.

Table 1. Asset categories, 1979-91 (source: CSO, various years).

| Year | Total | Gilts | UK Ordinary Shares | Overseas Ordinary Shares | UK Land Property |
|------|-------|-------|---------------------|--------------------------|------------------|
|      | (£bn) | (£bn) | %d                  | (£bn) %d                  | (£bn) %d         |
|      |       |       |                     |                          |                  |
| (a) Superannuation funds |       |       |                     |                          |                  |
| 1979 | 42.4  | 9.4   | 22.2                | 18.3 43.2                | 6.1 14.4         |
| 1980 | 54.7  | 11.7  | 21.4                | 24.1 44.1                | 8.2 15.0         |
| 1985 | 157.4 | 27.5  | 17.5                | 78.8 50.1                | 13.2 8.4         |
| 1990 | 302.7 | 27.9  | 9.2                 | 142.1 46.9               | 26.4 8.7         |
| 1991 | 343.7 | 24.0  | 7.0                 | 173.6 50.5               | 23.0 6.7         |

(b) Insurance companies: long-term funds

| Year | Total | Gilts | UK Ordinary Shares | Overseas Ordinary Shares | UK Land Property |
|------|-------|-------|---------------------|--------------------------|------------------|
|      | (£bn) | (£bn) | %d                  | (£bn) %d                  | (£bn) %d         |
| 1979 | 42.7  | 11.3  | 26.5                | 10.8 25.3                | 10.3 24.1        |
| 1980 | 53.7  | 14.6  | 27.2                | 14.6 27.2                | 12.4 23.1        |
| 1985 | 129.8 | 30.5  | 23.5                | 43.1 33.2                | 20.2 15.6        |
| 1990 | 232.3 | 31.1  | 13.4                | 81.0 34.9                | 34.8 15.0        |
| 1991 | 276.2 | 36.6  | 13.3                | 101.9 36.9               | 32.2 11.7        |

* Totals also include short-term assets, local authority securities, loans and mortgages, unit trust units, and other minor investments.

* This category includes British government securities but excludes local authority securities.

* This category also includes ground rents but excludes property unit trusts since comparable information was not available for insurance companies.

* Asset category as a percentage of the total.

The corollary of the sharp increase in equities held was a squeeze on other asset holdings, most notably property and government securities. The institutional investors switched out of these asset categories and substituted equities in their stead. Pension funds and insurance companies each halved their relative holdings of property. Insurance companies cut their gilt holdings (as a percentage of the total) by a half, but pension fund gilt holdings in 1991 was less than one third of the corresponding level in 1979.

However, one can also discern significant differences between the two types of institutions. First, property was and still remains a more important asset category for insurance companies. In 1979, property represented almost one quarter of holdings by insurance companies and so was on a par with gilts and UK ordinary shares. By 1991, their property holdings had declined to about 12% of the total, and ranked just after gilts as their third most important asset category. For pension funds, property as an asset category was and still is of far less significance. In 1979, property constituted about one seventh (14.4%) of total holdings, but had dropped to less than 7% by 1991, the fourth asset category of pension funds. Correspondingly, overseas equities have grown in significance to become the second most important asset, having overtaken property in 1983. The proportion of total assets represented by overseas equities increased almost eightfold after 1979 to reach 17.6% by the end of 1991.
According to Investment Property Databank (IPD) data, insurance companies' property holdings are heavily biased toward offices and London, and underrepresented in industrial property. They tend to be countercyclical investors, and net investment in 1991 was at its third highest of the 1981–91 period (IPD, 1992, pages 102–105). Pension funds, by contrast, are heavily weighted toward industrial property and are light in offices and London properties. They have rationalized in recent years and invested in retail properties at the expense of offices.

The decline in the institutions' demand for property must be placed in the context of competing returns on property, equities, and gilts over the 1980–92 period, which are given in Table 2. On an annualised basis, returns on property were lower than those of equities and gilts, and the picture does not alter even if we consider the 1979–92 period. Only in three out of twelve years to 1992 did property outperform its rival assets.

The decreasing relative significance of property on the institutions' balance sheets may appear to run counter to the thesis of deepening links between property and financial markets. This is to overlook several important points. First, the institutions remain significant property owners in absolute and relative terms. As we saw in section 2, they own some 40% of all commercial property in the United Kingdom. Second, they were significant traders of property in the 1980s as they sought to rationalise and upgrade their property portfolios to include mainly prime properties. Overall turnover increased from 10% in 1981, to 25% in 1987, before falling back to 5% in 1991 (IPD, 1992, page 102). The increased trading may be seen as evidence of increased short-termism toward property on the part of the institutions. These were operating in a significantly more liberalised environment in which competition between fund managers had sharpened and was increasingly based on relatively short-term performance measures. Third, and perhaps most significantly, in the current recession overseas buyers have begun to play a significant role in UK property markets, and many of these buyers are overseas financial institutions. Some £1.2 billion of UK property was purchased by overseas (mainly German) investors in 1992 (Financial Times 1993, page 6). It is just possible that the abolition of exchange controls and other deregulatory measures on the continent associated with the 1992 proposals may go some way toward reversing the impact on property markets of the 1979 abolition of UK exchange controls.

Table 2. Total returns on property, equities, and gilts, 1980–92 (source: IPD, 1993).

| Year | Property | Equities | Gilts |
|------|----------|----------|-------|
| 1980 | 15.9     | 34.1     | 20.9  |
| 1981 | 15.3     | 12.2     | 1.8   |
| 1982 | 7.4      | 28.8     | 51.3  |
| 1983 | 7.5      | 28.4     | 15.9  |
| 1984 | 9.5      | 29.8     | 6.8   |
| 1985 | 9.3      | 21.6     | 11.0  |
| 1986 | 11.5     | 26.4     | 11.0  |
| 1987 | 26.2     | 8.4      | 16.3  |
| 1988 | 27.9     | 12.8     | 9.4   |
| 1989 | 15.2     | 33.5     | 5.9   |
| 1990 | -9.4     | -6.7     | 5.6   |
| 1991 | -4.6     | 16.9     | 18.9  |
| 1992 | -3.0     | 19.9     | 18.4  |

*Annualised 1980–92* 8.4 18.5 11.8
4.2 Securitisation and financialisation

Securitisation [the development of (financial) asset-backed securities] historically was a response to a highly regulated financial environment. It can be traced to the development of repurchase agreements (or repos) for money-market securities in the USA in the 1950s. These repos are financial instruments (backed by the money-market securities) which are sold by their holders to raise short-term finance. However, modern securitisation proper began with the development of mortgage-backed securities in the USA in the 1970s (Francis, 1991; Mishkin, 1992). This type of securitisation involved the pooling of mortgages by lenders so that debt securities with mortgage collateral could be sold to investors. Essentially, it is a dis-intermediating process in which the original mortgage credit is refinanced by means of marketable debt securities. In other words it involves the transcending of barriers between the housing finance (mortgage) and securities markets and, as such, reinforces the trends stemming from deregulation.

The attraction of securitisation is that it eases the inflexibility and illiquidity of traditional mortgage finance in which both lender and borrower are locked into long-term contracts. Since the 1970s, the processes of deregulation and financial innovation have seen the variety of mortgage-backed securities proliferating as the providers of housing finance sought to increase the liquidity of the asset side of their balance sheets (Pryke and Whitehead, 1991). In fact, developments in securitisation have enabled many financial intermediaries to transfer some risk (interest rate, default, or prepayment risks) to investors and even to remove outstanding mortgages from their balance sheets before they are repaid. This had led to a major distinction between mortgage pass-through securities (MPTs) and real-estate mortgage conduits (REMICs) which allow the original mortgages to be taken off balance-sheet and other mortgage-backed securities such as mortgage-backed bonds (MBBs) and collateralised mortgage obligations (CMOs) which do not.

Since the 1970s, asset-backed financing has been generalised to many other types of financial assets such as car loans and credit-card receivables in the USA. More recently, asset-backed financing has been developed in the United Kingdom for corporate loans (Financial Times 1992, page 17). In all cases, securitisation involves some type of financial engineering on the part of financial services firms and is designed to transfer some part of the risk associated with particular assets. The concept of financialisation as developed by Coakley and Harris (1992) links asset-backed financing to the process of privatisation. Thus, although it shares some similarities with the process of securitisation, it also has other distinctive features relating to the ownership of property.

Both securitisation and financialisation facilitate the repackaging of relatively illiquid and apparently disparate assets into saleable and liquid entities. However, financialisation is distinguished from the process of securitisation to the extent that it has played a crucial role in facilitating privatisation. Privatisation entails the transformation of hitherto physical and illiquid assets into types of financial assets. This process can be described as financialisation. By contrast, securitisation involves the transformation of already existing financial assets.

Privatisation is broadly defined to embrace both the sale of state shareholdings in public enterprises and the sale of municipal housing to former tenants. Both forms of privatisation involve the creation of new marketable titles to ownership: equity in the case of public enterprises, and title deeds in the case of municipal housing. Both forms served in the 1980s to effect an enormous increase in private property ownership in the United Kingdom and elsewhere, and financial services firms were centrally involved. One could view privatisation as unleashing the
exchange-value aspect of state-owned property in which, typically, the use-value aspect is 'all'. The resultant increase in private-sector paper wealth had unintended effects on bank lending.

In the immediate aftermath of privatisation, banks came to view the newly created titles to private property as an additional pool of collateral on the basis of which new layers of credit relationships could be built. This credit multiplier is another factor which distinguishes financialisation from securitisation. Thus, even large commercial banks were seduced by the seemingly inexorable increase in the exchange value of property and the potential it appeared to offer as collateral or security for loans. As well as a sharp increase in mortgage lending, one of the upshots of this was a sharp increase in bank lending to property and construction companies. For instance, at the end of May 1992 outstanding sterling bank loans to property companies (£36.9 billion) in the United Kingdom exceeded those to the whole of manufacturing industry (£36.6 billion) (BEQB, 1992b, table 4). In addition, £14 billion was owed by construction companies. This increase in bank lending was not confined to the United Kingdom; similar trends can be observed in Japan, the USA, Australia, Sweden, and Norway (Danton, 1992, page 293). In the United Kingdom, foreign banks were involved in many cases of large property-loan packages through their international lending. The sharp increase in property-backed gearing contributed to the illusion that property really was a relatively low-risk, liquid investment and served further to encourage the property boom of the late 1980s.

What was overlooked in the midst of the late-1980s boom was the volatility of the exchange value of property, which progressively became disengaged from its use value. Its exchange value was determined by the apparently unlimited demand and artificially inflated turnover levels which the late 1980s boom engendered. The prospect of short-term capital gains swamped income streams in this new calculus for large numbers of investors. As in all speculative ventures, the bubble had to burst, and suddenly the use value of property and associated vacancy rates were all that mattered. The results were dramatic falls in property values across a range of countries, as indicated in earlier sections.

4.3 Integration of the housing finance circuit?

Until the late 1970s, housing finance in the United Kingdom was a relatively closed retail financial circuit. The building societies had a virtual monopoly over this circuit. The bulk of their savings was raised from individuals, and these funds were used to consolidate their stranglehold over the mortgage market. In other words, the housing finance circuit was almost exclusively retail rather than wholesale in nature. This gave the circuit a degree of autonomy from wholesale financial markets, as expressed, for example, in the ability of building societies to set their own interest rates.

In the 1980s, various waves of deregulation meant that, in the USA and the United Kingdom in particular, the hitherto closed circuit of housing finance has increasingly become intertwined with other financial circuits (Pryke and Whitehead, 1991). The upshot is that the specialist housing-finance firms (building societies and savings loans associations) are becoming increasingly like banks, as financial innovation inspired by both deregulation and loophole mining (Kane, 1981) erodes the market segmentation between the two. Moreover, commercial banks have come to play a significant role in the housing-finance circuit. Deregulation has led to two results in this finance circuit. One was that housing finance increasingly involves wholesale financial markets, and mortgage interest rates are more closely tied to wholesale money-market rates. The other result was increasing competition between
lending institutions, which partly fuelled the boom in retail credit and spending in the late 1980s.

Deregulation has abolished some of the previous constraints on the operations of building societies. First several new developments impacting on the liabilities side of their balance sheets can be identified. The societies have been able to tap the wholesale money and securities markets for funds since 1982 rather than having to rely solely on retail funds. In the 1982–92 decade, building-society wholesale funding increased fourfold (the source for these and subsequent data is BEQB, 1992c, page 284). The major sources of wholesale funding tapped were the commercial paper and bond (including the Euromedium-term note) markets. A note is a short-term bond with a maturity of less than five years. Medium-term notes typically have a maturity of three to five years. Moreover, since 1991 the societies have been allowed to diversify their wholesale liabilities by issuing permanent interest-bearing shares (PIBS) which qualify as tier-1 capital under the ‘own funds directive’ of the EC. So PIBS can be used instead of increases in reserves to boost societies’ core capital. In other words, the wholesale markets have become an important source of marginal liquidity and core capital for the societies. Second, the Building Societies Act 1986 has liberalised the asset side of societies’ balance sheets. Since then, societies have been permitted to commit up to 20% of their funds for nonmortgage purposes. The overall thrust of these deregulations is that building societies are effectively being transformed into banks and thus are being integrated into the wholesale finance circuits. The change in the formal status of Abbey National to a bank may well be a harbinger of future developments in the sector.

The transformation of building societies into banks parallels another major transformation affecting the banking sector: this is the development of bancassurance (Hart, 1992). This is a further consequence of deregulation measures which permit banks to engage in insurance activities, and insurance companies to engage in banking. As the housing-finance market generates related demand for a plethora of insurance products, including life policies for endowment mortgages and building and contents insurance, it seems logical that banks and building societies should contemplate direct involvement in insurance. The incursion into insurance markets may well turn out to involve an element of bad timing as the insurance sector itself has been hit by a series of disasters and a surge in claims.

5 Conclusions
In this paper, I have addressed the links between the real-estate and financial markets. It has been argued that a key to understanding the nature of these links is the complex nature of property as a commodity. Commercial property serves as both a use value for financial services firms and other occupiers and as an exchange value for investors. The use-value aspect was emphasised by the sharp increase in the demand for commercial real estate by financial services firms in the mid-to-late 1980s and in the wake of the crisis since 1990.

During the course of the 1980s the process of deregulation, combined with easy credit, served to effect a huge increase in the private ownership of property, and this contributed to the boom which preceded the current crisis. During booms, the exchange value of property reasserts itself, and property, by becoming apparently more liquid, increasingly takes on the attributes of a quasi-financial asset. The downside of this is that property prices then become more volatile, and the property market, like other financial markets, becomes more susceptible to crisis. In today’s relatively integrated markets within the advanced economies, the crisis is not confined to one country (the fact that the crisis is not generalised to all economies is
The integration of property and financial markets

indicative of the lack of complete integration among advanced capitalist countries. The overall impact is to increase the fragility of the financial system through contagion effects from the property crisis and vice versa. The bad property debts on banks' balance sheets in the early 1990s echo the Third World debts of the early 1980s. The crisis of the early 1990s has implied a new degree of fragility within the international banking system as evidenced by the deteriorating asset quality of banks' balance-sheet assets. This has stemmed not only from the collapse of numerous large property and construction firms but also from increased vacancy rates and the associated decline in rental levels and prices.

The other noteworthy development of the 1980s was the increasing integration of the housing finance and other financial circuits as a result of deregulation and securitisation. The significance of this is that what was hitherto a relatively closed retail financial circuit is being progressively intertwined with the networks or filières of wholesale financial markets. The impact of this will be to subject the former relatively stable circuit of retail housing finance to the vicissitudes and excesses of the wholesale markets. Moreover, the same credit boom which fuelled the price rise in commercial real estate led simultaneously to sharp increases in house prices. The current crisis is distinctive in the extent to which residential real-estate prices have slumped. Successive Tory governments may claim to have extended the boundaries of property-owning democracy since 1979, but this is of little consolation to the hundreds of thousands of people either disenfranchised by repossessions of their homes or spatially trapped by mounting negative equity on their current properties.

If the above analysis is correct, then real estate and the financial markets are now more closely linked than at any other historical period hitherto. Moreover, the enormous scale of outstanding bank lending to property and construction companies, combined with the financial straits within which many of these companies find themselves, implies a substantial 'locking-in' effect arising out of existing commitments. Banks are reluctant to place such ailing companies in receivership because of the substantial devaluation of their collateral, as represented by falling real-estate prices. This is not to assert that the real-estate and financial sectors are completely integrated, and the crisis has served to make banks and other financial services firms more cautious about future real-estate loans and investment.

One of the upshots of the growing financial links between real estate and the financial markets is the threat to the financial system posed by spillover effects from the current early-1990s crisis in the property markets. In this context, one can observe some interesting parallels and contrasts with the 1970s secondary-banking crisis. In both cases, a property boom was followed by a crisis, as property values collapsed. Despite some initial threats, both crises were confined to particular types of companies and did not spread to the rest of the financial system (although it may be too early to be conclusive on this aspect of the early-1990s crisis). However, there are distinct differences between the current property crisis and the 1970s secondary-banking crisis. The sources of finance are very different: smallish secondary banks supplied most of the external finance in the 1970s, whereas leading commercial banks have supplied large syndicated loans in the 1990s. A second difference relates to the types of property companies affected. In this regard, the current crisis has more cross-border ramifications as a greater number of multinational players are involved. Apart from the obvious example of Olympia and York, many leading Japanese companies are heavily involved in overseas (non-Japanese) property ventures, especially in the USA. Finally, it was only timely intervention by the Bank of England in the form of its lifeboat operation in the 1970s that prevented a contagion effect from the property to the financial markets (Reid, 1982).
To conclude, the threat posed by the current property crisis to the financial system is relatively more serious than it was in the 1970s, as the main players are the large banks rather than the small secondary banks. This reflects the increased integration of the property and financial markets. One of the worrying aspects of the current crisis is that a recovery in real-estate values seems remote even in mid-1993, and this seems likely to prolong the recession as consumer expenditure remains in a depressed state. The possibility of the property crisis spilling over to the financial system more generally—the so-called contagion effect—is thereby sustained.

Acknowledgements. I am grateful to Michael Pryke for helpful comments on earlier drafts. The comments by two anonymous referees are also acknowledged.

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