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In recent years, new funding mechanisms have begun to play a bigger role in the management and development of cities. The mechanisms vary in form according to the development level of a given country. The use of these funding mechanisms is called “financialization.” Financialization may be defined as the development of a market of debt, equity and derivative securities that represent real estate and buildings, without any given security being precisely identified with a given piece of real estate.

Treating land, houses or office buildings as financial assets is certainly not a new idea. While one need not go back to antiquity for examples, as early as the Second Empire in France, the emergence of bank-supplied real estate and property financing through the Crédit Lyonnais and Crédit Foncier banks fuelled cries of alarm against “financializing buildings.” In France, Great Britain and Germany at that time, the funding mechanisms were hardly more than simple housing loans, financing for building construction and the development of a mortgage market. These mechanisms differed greatly from “financialization” as we know it today.

In this essay, we wish to focus on a recent evolution, where more sophisticated funding mechanisms disconnect the financial product from the property that backs it. Securitization, real estate investment trusts and funds, the growth of real estate asset backed securities, collateralized debt obligations or CDOs, and a number of other financial products often traded on the stock market, all represent income streams from commercial and residential buildings. However, there is no direct link between the building and the financial product: the holder of the security knows that all of securities of the same type correspond to the ownership and income streams of a number of buildings, but unlike with a individual mortgage contract or loan, a specific building is not linked to a specific security.

These “mixed” securities are known as “structured products,” where the security is made up of a number of receivables or other debt instruments. The debt instruments may be housing loans combined to create mortgage-backed securities or MBS, or they may be consumer credit or other types of loans that make up asset-backed securities or ABS. The investor holding the security is not aware of the actual asset that guarantees the receivables’ value or income stream. The entire banking system may be contaminated by “toxic” products (toxic because the debt is unpaid) that lack all “traceability” i.e. the original assets linked to the securities cannot be identified.

Whilst it is not our intention here to provide a precise analysis of these funding mechanisms, we wish to indicate the impact they can have on the management of cities, especially with regard to housing and the outlook opened up by the current financial crisis.
The recent subprime loan crisis in the United States provides a good illustration. For a certain time, banks, mortgage companies and other real estate finance institutions, including government-sponsored enterprises such as Fannie Mae and Freddie Mac, provided financing for home purchases to “subprime” borrowers – those whose financial situation made loan repayment more risky than for “prime” borrowers who could guarantee repayment. The unguaranteed loans made to these risky borrowers were securitized or packaged, and thus turned into a marketable security. Investors did not know precisely what was in the debt security purchased, and were not necessarily aware of the risk, particularly because credit-rating agencies (such as Standard & Poor’s) obfuscated risk levels. Many of these securities, along with derivatives known as credit default swaps or CDS, make up “toxic products” that continue to circulate through the financial system.

As increasingly cyclical markets rise (and as long as they continue to do so), such financing is not a problem in the short term. This is especially true in the first years of the cycle and with special types of loans where the borrower reimburses interest only at favourable rates. This apparently virtuous financing worked until the beginning of 2007, as the subprime loan market grew and its debt securities were distributed far and wide, often blindly.

The market reversal that started in the United States at the end of 2007 created a crisis. At first, the crisis was limited to the subprime credit market and its debt securities, but it spread rapidly following the distribution of other structured products. Although it was not the only source of problems, the subprime credit crisis touched off a massive financial crisis that remains unresolved two years later.

Beyond the purely financial aspect of the crisis, it is worth noting two other effects of financialization and its funding mechanisms on urbanism and housing. The first relates to housing and the serious situation of indebtedness in which many families find themselves. In subprime loan cases in the United States alone, more than two million families were evicted from their homes in 2008 for non-payment of their mortgage. In many instances, the bank’s sale of the home did not cover the amount of the mortgage loan outstanding, a situation known as “negative equity.” The family loses its home and its mortgage debt in the foreclosure process. Foreclosures continued at a similar rate through the first quarter of 2009.

This perverse effect of globalization does not affect only the (very) developed countries. In Thailand, the combination of real estate financing and cyclical real estate market movements has also led to negative urban consequences. For example, an excess of mortgage financing in Bangkok led to a real estate bubble at the end of the 1990s. The bursting of this bubble helped precipitate the Asian financial crisis at the time. A number of real estate construction projects were abandoned. In particular, many office buildings – some practically finished – created a new kind of vast urban wasteland.

Ten years later, the real estate cycle has returned to a high point and construction projects flourish. However, the old, abandoned projects have not found new takers, for reasons of cost, obsolescence, pollution, etc. Instead, the urban fabric spreads out further to the periphery, leap-frogging the abandoned areas. Toll highways then link these new neighbourhoods. Thus, the end result exacerbates the incoherence of transportation, housing and employment systems. The combination of real estate and property financialization and the cyclical nature of real estate markets plays an increasing role in the structuring of cities. However, its short-term focus is not very compatible with structured urban planning.

Furthermore, it remains unclear whether sustainable development will find its place in the financialization of cities. Market cycles and speculative bubbles aside, how to develop sustainably remains an open question. Public action to address these issues is necessarily complex. It should prioritize regulation of derivatives into financial markets based on interest rate policy, require higher capital reserves, and take other actions as necessary.
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