

Real Estate Finance: REITs, Commercial Mortgages, and Housing Market Dynamics

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ABSTRACT

Real estate—residential and commercial property—is the world’s largest asset class, with global real estate value estimated at approximately \$326 trillion in 2020, representing 43% of global wealth. Real estate markets exhibit distinctive characteristics that differentiate them from securities markets: illiquidity, high transaction costs, heterogeneity (no two properties are identical), and local market segmentation. This paper reviews real estate finance theory and evidence across three major segments: residential real estate markets and mortgage finance; commercial real estate finance and capitalization rate determination; and Real Estate Investment Trusts (REITs), which provide liquid stock-market exposure to real estate economics. We examine housing cycle dynamics, the role of credit in amplifying housing booms and busts, commercial real estate valuation through the income approach, and the performance characteristics of REITs as an asset class in diversified portfolios.

Keywords: Real Estate Finance; REITs; Mortgage; Capitalization Rate; Housing Market; Commercial Real Estate; Portfolio Allocation; Housing Bubble

1. INTRODUCTION

Real estate’s central importance in household and institutional finance reflects both its scale and its distinctive risk-return characteristics. For most households, the primary residence represents both the largest single asset and the primary source of leverage in the household balance sheet—with a typical 20% down payment implying 5-to-1 leverage on the home’s value. This concentrated exposure makes housing price cycles among the most consequential determinants of household wealth changes. Piketty’s (2014) ‘Capital in the Twenty-First Century’ documents that real estate has been the dominant driver of capital-income ratio changes in developed economies over the past century, with real estate wealth growing from approximately 200% to 350% of national income between 1970 and 2010.

The 2007–2009 subprime mortgage crisis demonstrated the systemic financial consequences of housing market dysfunction: the combination of aggressive mortgage lending standards, mortgage securitization that distributed credit risk broadly without adequate due diligence, and concentrated household leverage produced a housing price collapse that wiped out \$7 trillion of household wealth and triggered the global financial crisis. Case and Shiller’s (1989) finding that housing prices are predictable—showing momentum and mean-reversion over long horizons—challenged the efficient markets hypothesis for residential real estate and motivated subsequent research on housing bubble identification and macroprudential policy for housing finance.

2. RESIDENTIAL HOUSING MARKETS

2.1 Housing Price Determinants

Residential property prices are determined by the interaction of demand factors (household income, employment, population growth, mortgage rates) and supply factors (land availability, construction costs, zoning regulations). Glaeser, Gyourko, and Saiz (2008) in the American Economic Review document that housing supply elasticity is the primary determinant of how demand shocks translate into price versus quantity changes: cities with elastic supply (Phoenix, Las Vegas) respond to demand increases primarily through construction while cities with inelastic supply (San Francisco, New York) respond primarily through price appreciation. This supply elasticity difference creates the bifurcated U.S. housing market: a subset of high-cost, supply-constrained cities with very high and volatile prices, and the majority of cities with affordable, stable housing.

2.2 Mortgage Finance

Residential mortgage finance involves complex interactions between the primary mortgage market (where loans originate), the secondary market (where loans are pooled and securitized into mortgage-backed securities), government-sponsored enterprises (Fannie Mae, Freddie Mac), and government mortgage agencies (FHA, VA). The 30-year fixed-rate mortgage—the dominant U.S. mortgage instrument—offers borrowers long-term rate certainty with the right to refinance (a prepayment option with significant value to borrowers and negative value to investors), creating complex prepayment modeling requirements for MBS investors. The Federal Reserve’s purchase of approximately \$2.5 trillion in agency MBS through three QE programs compressed mortgage spreads and reduced mortgage rates, directly stimulating the housing market.

3. COMMERCIAL REAL ESTATE

Table 1. Commercial real estate valuation methods.

Valuation Method	Formula	Applications
Income capitalization	Value = Net Operating Income / Cap Rate; Cap Rate = Risk-Free Rate + Spread	Stabilized income-producing property; quick valuation benchmark
Discounted cash flow	PV of projected NOI + terminal value; requires assumptions about rent growth and exit cap rate	Development projects; lease-up properties; portfolio valuation
Comparable sales	Price per square foot or per unit from recent transactions in same market	Cross-check; markets with frequent comparable transactions
Replacement cost	Land value + construction cost; property should not trade below replacement cost in equilibrium	Floor valuation; development feasibility analysis

4. REITS AS AN ASSET CLASS

Real Estate Investment Trusts (REITs), established by U.S. legislation in 1960 and now operating in over 40 countries, provide liquid stock-market exposure to commercial real estate by requiring distribution of at least 90% of taxable income as dividends (in exchange for pass-through tax treatment). Global REIT market capitalization exceeded \$1.7 trillion in 2022. Hoesli and Oikarinen (2012) review the evidence on REIT return characteristics: REITs exhibit higher return volatility than direct real estate (reflecting stock market co-movement), provide better liquidity, and offer more precise diversification across property sectors (office, retail, industrial, residential, healthcare, data centers) than direct investment. In long-run analyses, REIT returns are closer to direct real estate returns than to general equity returns, supporting their role as liquid real estate substitutes in diversified portfolios.

5. CONCLUSION

Real estate is simultaneously the world’s largest asset class, the primary store of household wealth, and a uniquely illiquid, heterogeneous, and locally segmented market that requires specialized finance theory and practice. Housing market dynamics—particularly the interaction of credit availability, supply constraints, and behavioral momentum—create boom-bust cycles with macroeconomic consequences that conventional financial market models do not capture. REITs have democratized real estate investment by providing liquid, diversified, professionally managed exposure to commercial real estate, though their stock market co-movement reduces their diversification benefits relative to direct real estate. Future research should examine how remote work permanently changes commercial real estate demand (particularly office), how rising sea levels and extreme weather affect real estate valuations in climate-exposed locations, and whether natural disaster insurance availability and pricing adequately reflects climate risk in residential real estate markets.

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