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Bank Exposure and Sensitivity to the Real Estate Market. Evidence from Cyprus during 2006-2012

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Abstract

Banking firms have recently been shifting significantly larger portions of their loan portfolios into real estate. This has caused concern about the continuing economic health of Cyprus banks, since changes in real estate market potentially have a significant impact on bank values and profitability. This scenario is especially critical during real estate crises, when bank losses tend to increase dramatically, placing the entire financial system at risk of collapse, as it was the case in the recent international subprime crisis. Many of the problems in the Cyprus banking sector are home-grown and relate to overexpansion in the property market as consequence of banks' poor risk management practices. Furthermore, the financial sector in Cyprus seems to be vulnerable because of its size relative to that of the domestic economy. The handling of problems in the sector has been complicated by the sensitivity of collateral valuations to property prices, and banks have used certain gaps in the supervisory framework to delay the recognition of loan losses, thus leading to significant underprovisioning. The results point out that the three major banks in Cyprus (The Bank of Cyprus, Laiki Bank and Hellenic Bank) have high exposure to the local real estate market. Having estimated how big the shortfall between property values and their collateral is, this study show that a further decline in property values will begin to result in bank's credit risk and loan restructuring. Conclusion is drawn that there is a positive relation between bank stock returns and real estate market after controlling for general market conditions and interest rates.