

## The Recent

## Cypriot Property

## Boom and Bust Cycle

The financial stability of the Cypriot banking system is highly correlated to the real estate sector as the lending criteria that the banks applied reinforced the real estate crisis. The large credit expansion of the years 2006-2008, especially to the real estate sector, led to a real estate "bubble". As a result, the real estate prices collapsed, causing a large increase in the non-performing loans (NPL) that were collateralised by real estate. To date, loan origination remains at extremely low levels and consequently the ability of buyers to buy property is low and the property prices remain depressed. This is what I had described as the "cyclical" effect of the lending criteria and policies employed by the Cypriot banks during the boom.

Many times, particularly during the inexorable rise in property prices in the 2004-2008 period, the banks in Cyprus "underestimated" the credit risks implicit in mortgage loans. This could be attributed to various reasons, such as the lack of sophisticated systems of risk assessment and the lack of reliable data and information. The main reason, however, is that the continuous increase in property prices created a false sense of security in Cypriot banks and led to further credit expansion.

This behaviour was one of the main reasons that kept property prices ever increasing, and led to the subsequent deterioration of the loan portfolios of domestic banks. Currently, the sharp decline in property prices and the depreciation of mortgaged properties increases the credit risk and the bank

capital requirements even further. The shortage in the supply of credit by the banks, reduces the demand in properties, commercial investments etc., inevitably reinforcing the downward trend of real estate prices.

The Central Bank of Cyprus (CBC) and the banks themselves have to consider the consequences of the property prices decline and the restructuring of their portfolios and adapt their policies accordingly. In order to do this, collection of data for all mortgaged properties, as well as data analysis using statistical/ econometric models and cartographic tools are needed. Using such tools, they can, for example, calculate the geographical concentration of properties/mortgages, the risk assessment to the sale/ divestment of specific properties in specific areas, etc.

The purchase of properties has become more vulnerable to the fluctuations of the prices because of the banking system influence. Theoretically, the decision of granting a loan must be based on long-term projections regarding the future value of the financed property until the repayment of the loan. Also, the repayment ability of the borrower has to be assessed and seriously considered. The lack of adequate information on the evaluation of the prevailing market trends and the possible future prices, however, prevents a correct evaluation. The funding decisions as a result, are primarily based on the prices of similar properties during that period.

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The experience from international markets indicates that property prices are subject to considerable fluctuations, which may or may not coincide with the "economic cycles". Under certain circumstances, these fluctuations may be reinforced and become much more intense due to the credit policy applied by credit institutions, when this policy is of cyclical nature. In any case, monitoring the evolution of property prices should be of direct interest to the monetary and supervisory authorities. As the recent

experience from the domestic financial crisis points out, the sharp decline of property prices may have a significant impact on the banking sector and thus on the real economy of the country.

It is not a big surprise that both the authorities and the banks are reviewing their credit rating systems and their methods of monitoring mortgages/ properties so as to better manage their portfolios.

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